

January 1988

The Internal Division of Powers in Corporate Governance

Richard M. Buxbaum

Follow this and additional works at: <https://scholarlycommons.law.case.edu/cuslj>



Part of the [Transnational Law Commons](#)

Recommended Citation

Richard M. Buxbaum, *The Internal Division of Powers in Corporate Governance*, 13 Can.-U.S. L.J. 391 (1988)
Available at: <https://scholarlycommons.law.case.edu/cuslj/vol13/iss/17>

This Article is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Canada-United States Law Journal by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.

The Internal Division of Powers in Corporate Governance

*Richard M. Buxbaum**

I

INTRODUCTION

A. Background and Typology

The concept of shareholder participation in the governance of the publicly held corporation presumes the need for representative government.¹ A large organization, whatever its mission, cannot achieve its goals by constituting its members into an ongoing committee of the whole. Even participatory democracies, worker-owned enterprises, and cultural revolutions accept the distinction between mass and cadre, wherever they may at times draw the line between the two.

The opposite constraint, however, is equally valid. A dividing line implies the existence of residual, policy-setting, ratifying, or monitoring powers in the principal-agent relationship.² Members' participation rights may differ in private economic firms and political units, in part because the profit-maximization or allocative-efficiency goal of private firms may be optimized only if the firm is operated or supervised by a management more autonomous than that managing political units.³ This

* Professor of Law, Boalt Hall School of Law, University of California, Berkeley. A.B. 1950, LL.B. 1952, Cornell University; LL.M. 1953, Boalt Hall School of Law, University of California, Berkeley.

This is a substantially revised and expanded version of a paper presented at the 1984 Comparative Corporation Law Conference conducted by the Canada-United States Law Institute of Case Western Reserve University and the University of Western Ontario. The paper was originally published in 73 CALIF. L. REV. 1671 (1985) and is reprinted with the permission of the author.

¹ "A corporation requires some form of government, as does any entity composed of individuals. The government of a corporation is generally entrusted to a board of directors comprised of the elected representatives of the shareholders." 1 H. MARSH, MARSH'S CALIFORNIA CORPORATION LAW § 8.1 (2d ed. 1983); see also MODEL BUSINESS CORP. ACT §§ 35-36 (1979) (provisions for power of board and election of directors); M. EISENBERG, THE STRUCTURE OF THE CORPORATION 1-6 (1976).

² See MODEL BUSINESS CORP. ACT § 39 (1979), which states in pertinent part, "[a]ny director or the entire board of directors may be removed, with or without cause, by a vote of the holders of a majority of the shares then entitled to vote at an election of directors." To similar effect is CAL. CORP. CODE § 5222 (West Supp. 1985) (removal of directors without cause).

³ So-called "managerialists" espouse the most extreme version of this proposition. See M. EISENBERG, *supra* note 1, at 24-29 (contrasting managerial corporate model with models based on shareholder democracy and on client-group participation). An exception, of course, may be the close corporation, where there may be control by owners because management and ownership are the same. See, e.g., DEL. CODE ANN. tit. 8, § 351 (1983) (management by stockholders of close corporation).

distinction may limit, but it does not eliminate, owners' participation rights.

Of course, there are conceivable forms of investment in which owners would have no participation rights. The pure trust (not today's real estate investment trust) is a possible example.⁴ But these kinds of models are not useful for two reasons. First, existing corporation law is based on shareholder participation. Therefore, participation should be undermined only by direct legislation, not by unsympathetic interpretation. Second, the modern notion that a market for control exists, and that it functions to help reduce agency-cost and thus improve efficiency, is predicated on the existence of shareholder voting. It is through the "concentration" of shares by transfer to a control-bidder that the control market is supposed to function.⁵ I begin, therefore, with what seems to most analysts of corporation law a defensible if not an essential position: owner participation in corporate governance is necessary and proper.

It is arguable that shareholders share only the instrumental common aim of profit maximization, and it may be correct that they can realize that goal in part through the monitoring effect of a market for control. These assumptions, however, cannot themselves justify the absorption of all ultimate decisionmaking power of owners by their managerial agents. Exit from a political unit is not the sufficient condition of political responsibility. It likewise cannot be the sufficient condition of an economically and socially acceptable private enterprise system. Loyalty remains an essential if undervalued element of corporate as well as political systems⁶ so long as the surplus savings of private households flow to firms in significant part as the result of voluntary, willed investment decisions.⁷ A shareholder's "belief" in a Xerox or an Apple Computer may be illusory, but it is an illusion worth money to that enterprise. Owner loyalty, like customer loyalty, gives the enterprise, and its managers, a positional

⁴ The fullest argument for this passive form is that of G. ROTH, *DAS TREUHANDMODELL DES INVESTMENTRECHTS* 172-73, 332-34 (1972) (arguing that the pure trust, which involves a higher fiduciary responsibility and recognizes the need for external legal enforcement, better controls management than the corporate form of ownership with its myth of small investors supervising and controlling management). *But see* D. BAUM & N. STILES, *THE SILENT PARTNERS* 153-67 (1965) (arguing that passive institutional investors may have a duty to exercise their participation rights).

⁵ *See, e.g.*, Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-19 (1965) (market for corporate control functions through the processes of proxy fights, direct purchase of shares, and mergers).

⁶ This much-used paradigm of exit, voice and loyalty stems from A. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* (1970). On its application to shareholders' behavior options, see A. HIRSCHMAN, *ESSAYS IN TRESPASSING* 218-19 (1981).

⁷ Whether this form of investment in fact will remain important is another matter. *See* Clark, *The Four Stages of Capitalism: Reflections on Investment Management Treatises*, 94 HARV. L. REV. 561, 565-68 (1981) (discussing the phenomenon of savings through institutional actors, such as pension plans, and its relation to corporate finance and governance); *see also* Buxbaum, *Juridification and Legitimation Problems in American Enterprise Law*, in *LAW AND ECONOMIC POLICY: ALTERNATIVES TO DELEGALISATION* (T. Daintith & G. Teubner eds., forthcoming).

advantage in the endless battle for profile, power, and profit. And loyalty cannot be obtained without voice. It would be a strange polity whose members love it only because they can leave it.

Once the need for participation is established, the issue becomes one of degree. Whether any particular decision or type of decision should be made by the principal or by the agent depends on the balancing of more or less incommensurable instrumental values. The statutory and common law rules that are reviewed below are nothing more than the composite of a large number of such balancing judgments.

Hirschman's concepts of exit, loyalty, and voice can serve as a framework for the various rules concerning corporate governance. One set of these rules particularly relevant to merger transactions involves adequate conditions of exit, such as the dissenting shareholders' appraisal remedy.⁸ Other rules implicate conditions of loyalty. For example, the noncontrolling shareholders have the right to enjoin or be compensated for a manager's or a majority's breach of fiduciary duty.⁹ Another more complex set of rules involves adequate conditions of voice; that is, transactions may be classified as subject or not subject to shareholders' participation in decisionmaking in the first place. Current interest in the role of markets as rule substitutes has led to a focus on exit as a kind of first among equals among Hirschman's three elements. It is probable that this abstraction—"exit"—lends itself more immediately to directly instrumental rules (such as the appraisal remedy) than does an abstraction like "voice." One can agree on the desirability of voice without necessarily agreeing that this or that transaction deserves a shareholder vote. Nevertheless, each criterion has its normative importance. Moreover, there is not a necessary correlation between any one criterion and different normative ends. Voice and loyalty, as well as exit, support the values associated with the principles of allocative efficiency. Likewise, exit, as well as voice and loyalty, supports the values associated with the social and political legitimacy of the corporation.

These organizing visions of efficient markets for shares and of efficient markets for management are of limited utility because corporations are more like people than like money. They come in a large variety of sizes and shapes, of ownership diffusion and concentration, and of pas-

⁸ See, e.g., Comm. on Corporate Laws, Am. Bar Ass'n Section of Corp., Banking & Business Law, *Changes in the Model Business Corporation Act Affecting Dissenters' Rights*, 32 BUS. LAW. 1855 (1977).

⁹ See R. JENNINGS & R. BUXBAUM, CORPORATIONS—CASES AND MATERIALS 1141-42 (5th ed. 1979) (alternative remedies for minority shareholders threatened by mergers); Note, *Singer v. Magnavox Co.: Delaware Imposes Restrictions on Freezeout Mergers*, 66 CALIF. L. REV. 118, 135 (1978) (suggesting use of judicially supervised renegotiation of cash-out price to dissenting shareholders). An interesting recent case illustrating the interaction between an appraisal remedy and a "quasi-appraisal" remedy (to borrow the preemptive rights terminology) is *Leader v. Hycor, Inc.*, 395 Mass. 215, 479 N.E.2d 173 (1985) (remanding for fair-price determination where minority shareholders forced to accept redemption under majority's recapitalization scheme).

sive and active member involvement.¹⁰ This variety confounds simplistic efforts to impose a "rule of markets" on the upper, public end and a "rule of contract" on the lower end of what, after all, represents not a dichotomy but a spectrum of firms. The reality of corporate diversity also has institutional implications.¹¹ Legislatures may be emperors over rules, but courts are emperors over events. By definition events fall between rules whenever, as is usual, the rules are more abstract and less detailed than the events they purport to control. Since courts cannot work well with simple, dichotomous rules or models unless the courts have a reasonable amount of "judicial discretion,"¹² litigation shapes and tests rules as it applies them.¹³

The following Article is a review of shareholder participation in corporate governance and of shareholder relief from coerced acceptance of majority and managerial decisions. It represents an effort to provide a status report on that reciprocal relationship. It examines that relationship as it exists today and as it might be predicted and prescribed to look tomorrow.

B. Reserved Power and Collective Decisionmaking

Shareholder participation, when it exists, generally is collective rather than individualized. The elimination of the *Dartmouth College*¹⁴ Court's impairment-of-contract doctrine by legislative recourse to reserved-power clauses of the state constitutions¹⁵ foreshadowed and then supported the effective use of individuals' surplus in joint production units called firms or corporations. Since only jointly owned property—i.e., pooled assets—could produce goods efficiently, jointly made decisions, even about important structural events, were accepted in order to facilitate corporate organization and economic growth. In that sense *Seattle Trust & Savings Bank v. McCarthy*¹⁶ is only the most recent in a

¹⁰ See Buxbaum, *Corporate Legitimacy, Economic Theory, and Legal Doctrine*, 45 OHIO ST. L.J. 515, 517, 541-42 (1984).

¹¹ Cf. generally *id.* at 542 ("That corporations are neither large or small nor 'market' or 'nonmarket,' but range along a continuum, might serve as a metaphor for this entire discussion about the role of economic theory and legal doctrine.").

¹² M. SHAPIRO, COURTS 28 (1981) ("Nearly all contemporary students of courts agree that courts do engage in at least supplementary and interstitial lawmaking, filling in the details of the statutory or customary law.") (footnote omitted).

¹³ E. LEVI, AN INTRODUCTION TO LEGAL REASONING 3 (1949).

¹⁴ Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheat.) 518 (1819).

¹⁵ H. BALLANTINE, BALLANTINE ON CORPORATIONS 644-47 (rev. ed. 1946). State statutes typically specify that by chartering a corporation, the state reserves the power to alter, amend, or repeal that charter. This approach avoids violating the contract clause, U.S. CONST. art. I, § 10, cl. 1.

¹⁶ 94 Wash. 2d 605, 606-07, 617 P.2d 1023, 1025 (1980) (en banc) (reserved power clause requires that shareholder "be deemed to have consented" to amendment to charter eliminating preemptive rights); see *Gottlieb v. Heyden Chem. Corp.*, 33 Del. Ch. 177, 91 A.2d 57 (Del. 1952) (where majority of shareholders ratify board's arguably self-serving action, dissenting shareholder has burden of proving issuance of stock options to board not within sound business judgment). Cf.

well-known line of cases running from *Federal United Corp. v. Havender*¹⁷ through *McNulty v. W & J Sloane*¹⁸ and *Bove v. Community Hotel Corp.*¹⁹ These cases recognize that states, under the reserved-power clauses, are empowered to allow majorities to effect corporate changes in spite of minority opposition. That *Seattle Trust* involved preemptive rights while *Havender* involved dividend arrearages is of no matter. Both demonstrate the relation between jointly pooled assets and jointly made decisions bearing on the use and disposition of those assets. Whether the individual right is one of proportional voting power or proportional returns, it can be compromised by collective action of the owners.²⁰

Yet even at this preliminary stage of black letter principles the reality of the interrelationship of size and management by owners intrudes. In companies with significant owner-operator overlap, and with little opportunity for exit through stock markets, the minority's preemptive rights in fact are protected and on an individualized basis. These rights, characterized as "quasi-preemptive," are protected by the courts' own reserved power, embodied in their fact-oriented discretionary duty to do equity.²¹ Here, then, is a first demonstration of the previously mentioned problem of applying dichotomous legal rules to the finely gradated reality of corporate structure.

C. *Disenfranchisement and the Proper Concept of Statutory Models*

There appears to be a trend against maximum participation for normally nonvoting shareholders in decisions about structural transactions.²² Both those in favor of participation and those against it use the

generally Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243, 298-306 (1954) (discussing methods for the alteration of preferred stock's contractual rights).

¹⁷ 24 Del. Ch. 318, 11 A.2d 331 (Del. 1940) (preferred shares with dividend arrearage could be converted into survivor corporation shares in light of merger statute and common law reserve power concept giving shareholders notice thereof).

¹⁸ 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945) (internal recapitalization through conversion of preferred shares with dividend arrearages into new common and preferred shares impaired no contractual rights because arrearages were not a debt).

¹⁹ 105 R.I. 36, 249 A.2d 89 (1969) (elimination of preferred stock and accumulated dividends via merger of parent and subsidiary not unfair to minority dissenters, given appraisal remedy).

²⁰ See generally N. LATTIN, *THE LAW OF CORPORATIONS* 582-86 (2d ed. 1971). "Theoretically, there would seem to be no bounds to contractual changes impliedly consented to by the shareholder through the state's reservation of the power to amend or repeal corporate charters." *Id.* at 582. Cases from diverse jurisdictions allow changes in all sorts of rights of shareholders. See *Yoakam v. Providence Biltmore Hotel Co.*, 34 F.2d 533 (D.R.I. 1929) (preferred share cumulative dividends abolished); *Maddock v. Vorclone Corp.*, 17 Del. Ch. 39, 147 A. 255 (1929) (cumulative voting eliminated); *Johnson v. Bradley Knitting Co.*, 228 Wis. 566, 280 N.W. 688 (1938) (payments to sinking fund reduced). For additional examples, see N. LATTIN, *supra*.

²¹ *E.g.*, *Schwartz v. Marien*, 37 N.Y.2d 487, 335 N.E.2d 334, 373 N.Y.S.2d 122 (1975). See generally R. JENNINGS & R. BUXBAUM, *supra* note 9, at 882-92.

²² A surprisingly large number of cases involving preferred shareholders exemplifies this trend. See *infra* text accompanying notes 61-95.

statutory material to their end. The disenfranchisers, however, seem to be prevailing on both questions of consistency and policy. In deciding for disenfranchisement, some courts take inarticulate refuge in the literal application of an underlying enabling statute while others use literal statutory language in the service of their articulated version of policy.

The reason for these tendencies in statutory construction, I believe, lies less in the substantive policies themselves than in the ever-increasing dysfunctionality of ever more elaborate statutes.²³ The proponents of minimal shareholder participation first exploited inadvertent statutory gaps to create what originally were simply loopholes. They then quickly came to argue that those irregularities represented policy choices, choices that in turn justified the elimination of remaining protective provisions now "out of sync" with a "properly understood" statute. Examples of this evolution in the field of shareholder voting rights include the well-known Delaware approach to the de facto merger doctrine²⁴ and Manning's treatment of the appraisal remedy.²⁵

This kind of approach gained momentum when Delaware jurisprudence legitimated the "equal dignity of statutes" nostrum in *Hariton v. Arco Electronics, Inc.*²⁶ It has become even bolder with the recent vulgarization of "market discipline" substitutes for legal rules that first gained currency in the late sixties and early seventies. I believe, however, that the most telling reasons for the success of the rhetorical battle to reduce collective, let alone individualistic, shareholder participation in important governance decisions are institutional ones—in particular, judicial-institutional ones.

For example, as I have sketched elsewhere, the courts pay exagger-

²³ For an example, see Buxbaum, *The Dissenter's Appraisal Remedy*, 23 UCLA L. REV. 1229, 1253-54 (1976):

The appraisal process has been cut back, not fostered, by the new statute. Even where available, it is exceedingly technical and difficult to use. . . . [The statute] has, almost as a law of nature, multiplied the opportunities for dubious combinations and permutations of shaping transactions while suggesting, in the very prolixity of the enabling detail, that abuses of fiduciary relations are now blocked and that the courts can relax. That is not the case.

²⁴ *Hariton v. Arco Electronics, Inc.*, 41 Del. Ch. 74, 188 A.2d 123 (Del. 1963); see M. EISENBERG, *supra* note 1, at 218-23.

²⁵ Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962), justifies limits on the appraisal remedy based on a critique of its historical and philosophical development without discussing second-order questions of statutory construction.

²⁶ 41 Del. Ch. 74, 188 A.2d 123 (Del. 1963).

[T]he sale-of-assets statute and the merger statute are independent of each other. They are, so to speak, of equal dignity, and the framers of a reorganization plan may resort to either type of corporate mechanics to achieve the desired end. This is not an anomalous result in our corporation law. . . .

. . . "[T]he general theory of the Delaware Corporation Law that action taken pursuant to the authority of the various sections of that law constitute acts of independent legal significance and their validity is not dependent on other sections of the Act."

Id. at 76-77, 188 A.2d at 125 (quoting *Langfelder v. Universal Laboratories*, 68 F. Supp. 209, 211 n.5 (D. Del. 1946)); see M. EISENBERG, *supra* note 1, at 218-23.

ated respect to the black box of managerial functions.²⁷ This is coupled with an equally exaggerated aversion in most of these cases to the status of the complainants and their contingent-fee-motivated champions.²⁸ With no responsibility for the intricate and opaque machinery that produces the goods and services on which we all depend, how can these hired gadflies command respect? This combination of reverence and disdain cannot generate much reflection about the policies underlying statutory rules of shareholders' involvement in corporate life. Indeed, it reduces those statutes to paper guardians whose power can be dispelled by invoking shibboleths and incantations.²⁹

It takes a powerful court to overcome these states of mind. Some populist exceptions aside,³⁰ the more balanced consideration of these issues tends to come from those judges sufficiently sophisticated and experienced neither to fear looking behind the screen of expertise nor to disparage the invisible hand that can convert even the selfish private litigant into an agent for the public good.³¹

²⁷ Buxbaum, *supra* note 10, at 517, 538-39, 543.

²⁸ *Id.*; see also Coffee, *The Unfaithful Champion: The Plaintiff As Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5, 8 & n.19 (listing cases expressing doubts about the viability of shareholder actions and noting the "uncomfortably ambivalent attitude" of the legal culture towards the plaintiff's attorney); Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 204-11 (1979). Cox, *Compensation, Deterrence and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984), provides a full and balanced review of the role of derivative litigation, much of it aimed at the disparate treatment of "care" and "loyalty" charges. The formal modeling of "strike suits" in economic terms also has been undertaken. See, e.g., Rosenberg & Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3 (1985).

²⁹ Troublesome examples of this approach are *Lewis v. Anderson*, 615 F.2d 778 (9th Cir. 1979), and *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). See Buxbaum, *Corporate Derivative Litigation: Delaware Drops the Other Shoe*, 6 CAL. BUS. L. REP. 8 (1984); see also Buxbaum, *Conflict-of-Interest Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 CALIF. L. REV. 1122 (1980); Coffee & Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 COLUM. L. REV. 261 (1981); Dent, *The Power of Directors to Terminate Shareholder Litigation: the Death of the Derivative Suit?*, 75 NW. U.L. REV. 96 (1980).

³⁰ See, e.g., *Remillard Brick Co. v. Remillard-Dandini Co.*, 109 Cal. App. 2d 405, 241 P.2d 66 (1952).

³¹ Two good examples are *Joy v. North*, 692 F.2d 880, 885-87, 890 (2d Cir. 1982) (Winter, J.), *cert. denied*, 460 U.S. 1051 (1983), and *Lasker v. Burks*, 567 F.2d 1208, 1211-12 (2d Cir. 1978) (Lumbard, J.), *rev'd on other grounds*, 441 U.S. 471 (1979). See especially the following characterization of the "diffident" approach in *Joy*:

It is here that we part company with Judge Cardamone. While he recognizes that the business judgment rule has never applied to corporate decisions tainted by a conflict of interest, he argues that the conflict in the defendants' creation of a committee to determine whether this action should be terminated is wholly cured by a judicial finding that the committee acted independently and in good faith. This view is a major departure from the traditional scrutiny courts have given to the underlying fairness of corporate decisions which benefit directors. . . . To be sure, Judge Cardamone is correct in anticipating difficulties in judicial review of the recommendations of special litigation committees. These difficulties are not new, however, but have confronted every court which has scrutinized the fairness of corporate transactions involving a conflict of interest.

692 F.2d at 888 (citations omitted).

The following review of specific legal issues produces rather particularized critiques and suggestions. Taken all together, however, it will suggest that the perceptible current erosion of shareholder participation in corporate governance—and especially in corporate restructuring decisions—has profound consequences for the effective functioning of corporations and for their socially perceived legitimacy. These developments should provoke concern from proponents of pure economic efficiency and from proponents of less precisely formulated corporate constitutional models. Thus both viewpoints are sketched and taken into account as these developments are considered in this Article.

II GOVERNANCE

The large topic of shareholder participation in corporate governance exists in an often overlooked procedural context, that of disclosure and information flow, which is the subject of Section *A*. The major part of this Article is devoted to problems of shareholder voting rights. That topic is broken down into the special problems of special shares and the general problems of direct and indirect erosion or elimination of the voting rights of residual equity holders. These developments are explored in Section *B*. Section *C* takes up the recent proliferation of nonvoting common shares. The extent of shareholder participation also is influenced by (and premised upon) the existence of adequate dissenters' remedies, which are discussed in Section *D*. Section *E* reviews the most recent judicial inroads on the business judgment rule.

A. Informed Participation

Informed participation is as important as participation per se. Furthermore, the distinction between passive participation in a simple ratification mode and active participation in the agenda-setting sense is an essential aspect of the overall topic of shareholder participation in corporate governance. This section discusses developments affecting these aspects of participation by shareholders.

1. Information Requirements

A preliminary, often-slighted topic is the level of information corporations must provide to enable informed shareholder participation in the decisionmaking allocated to them. It is not necessary here to review the well-known federal regime of periodic reporting and reporting via the proxy materials.³² It is useful, however, to mention some recent state law developments that aim at providing adequately prepared and ade-

³² 15 U.S.C. §§ 78f, 78n (1982 & Supp. II 1984). See generally L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 487-92, 509-25 (1983).

quately detailed information, both on a periodic basis and for specific meetings and decisions.

The current revision of the Model Business Corporation Act was unable to resolve the recurring question of whether the information provided shareholders should be in audited form.³³ Again, the problem of corporate typology stands in the way. For the small corporation, the investor benefit of audited information is outweighed by the indirect cost of providing certified financial statements which the company may not normally commission. Thus, both section 16.20 of the revised Model Act³⁴ and section 1501 of the California Corporations Code³⁵ require GAAP-based audited statements for shareholders only if such statements are prepared anyway. California, however, does require GAAP-based reports in any event for corporations with more than 100 record-owners.³⁶

In addition, states have failed to require disclosure of information specifically salient to the evaluation of the stewardship of directors, and thus to reelection decisions. So far only California has a statute requiring corporations with more than 100 owners, if they do not fall under the federal regime, to report substantial conflict-of-interests transactions between any director and the corporation.³⁷ This is a requirement that could easily have been extended through the Model Act, since few costs and substantial benefits flow from the publicizing of this particular information. Except for two minor reporting requirements of somewhat different provenance—director indemnification³⁸ and share issuance against promissory notes³⁹—the proposed Model Act revision has ignored the California invitation.

2. The Adequacy of the Proxy-Solicitation Process

The elaborate federal system of minimum mandatory disclosure for annual meetings and, more particularly, for special meetings considering such structural questions as mergers again is well-known and needs no elaboration here.⁴⁰ The schedular approach has proved adequate over the decades. The current deregulatory climate, however, naturally and properly also has affected this aspect of securities regulation.

The attempt of the SEC during the Carter administration to use the disclosure of directors' stewardship records as a means with which to

³³ MODEL BUSINESS CORP. ACT ANN. § 16.20 comment, at 1768-70 (1985).

³⁴ *Id.* § 16.20.

³⁵ CAL. CORP. CODE § 1501 (West Supp. 1985). See 2 H. MARSH, *supra* note 1, § 12.4, at 99.

³⁶ CAL. CORP. CODE §§ 114, 1501 (West Supp. 1985).

³⁷ CAL. CORP. CODE § 1501(b)(1) (West Supp. 1985) (requiring disclosure of conflict-of-interests transactions exceeding \$40,000).

³⁸ MODEL BUSINESS CORP. ACT ANN. § 16.21(a) (1985).

³⁹ *Id.* § 16.21(b).

⁴⁰ See *supra* note 32.

mandate certain substantive behavior by directors⁴¹ for all practical purposes has been abandoned. Materiality is once again a unitary notion based on financial concepts.⁴² The lower threshold notion, that events are material if they presage how directors may perform in more material situations, is a product of the post-Watergate era that has not maintained itself.⁴³

The adequacy of information-flow for merger decisions tends to be challenged as a routine matter by dissidents under the rule 14a-9 jurisprudence.⁴⁴ So long as this type of action can continue for reasons of federalism, more stringent federal court scrutiny of the fairness of such transactions will continue under the guise of disclosure review.⁴⁵ This will be true no matter how state law attempts to circumscribe the remedies available to dissenters from structural transactions.⁴⁶

State law, on the other hand, provides little meaningful review of either mandatory minimal disclosure or the adequacy of whatever disclo-

⁴¹ The SEC attempted to use disclosure to solve the problem of corporate bribery. *See Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650, 654-55 (2d Cir. 1979), *cert. denied*, 445 U.S. 951 (1980). The Second Circuit reversed dismissal of a suit for violations of § 14a of the Securities Exchange Act of 1934, 15 U.S.C. § 78n (1982 & Supp. II 1984). The plaintiff had alleged that proxy materials for election of directors failed to disclose payment of bribes by the corporation, but the plaintiff had not alleged that the directors received kickbacks. The court noted, but did not reach, the issue of the need to allege kickbacks, i.e., self-dealing by directors. *Weisberg*, 609 F.2d at 654; *see also* *Maldonado v. Flynn*, 597 F.2d 789, 796-98 (2d Cir. 1979) (failure to disclose in director election proxy material that directors had approved stock option for some directors, knowing of impending tender offer); *Berkman v. Rust Craft Greeting Cards, Inc.*, 454 F. Supp. 787, 791-92 (S.D.N.Y. 1978) (failure to disclose in director election proxy material that reason for lack of unanimity in renomination of directors was objection to those directors failing to disclose hired investment banker's conflict of interest in a tender offer).

⁴² The cyclical history of materiality is chronicled in the SEC's releases. *Compare* Sec. Exch. Act of 1934 Release No. 13,185 (Jan. 19, 1977), [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,896 (proposed stringent requirements concerning disclosure of bribes in proxy statements consonant with courts' views in *Weisberg v. Coastal States Gas Corp.*, 609 F.2d 650 (2d Cir. 1979), *cert. denied*, 445 U.S. 951 (1980) and *GAF Corp. v. Heyman*, 724 F.2d 727 (2d Cir. 1983)) *with* Sec. Exch. Act of 1934 Release No. 15,571 (Feb. 15, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,960 (withdrawing the same).

⁴³ In *Gaines v. Houghton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982), the Ninth Circuit held that the nondisclosure of "simple breach of fiduciary duty/waste of corporate assets," e.g., then-not-illegal foreign bribery by Lockheed, not involving self-dealing, "is never material for § 14(a) purposes." The court reasoned that shareholders and federal securities regulations are mainly concerned with economic performance. *Id.* at 776-77; *cf. id.* at 777 n.24 ("There are clearly instances of illegal conduct by director-nominees, unrelated to self-dealing . . . which would have to be disclosed, especially if they involved criminal convictions."). *But see* *GAF Corp. v. Heyman*, 724 F.2d 727, 739-43 (2d Cir. 1983). In *GAF*, the court although holding omission immaterial, extensively analyzed the impact of the undisclosed fact that the successful, insurgent director was a defendant in a civil suit involving a family dispute, despite the noneconomic and noncriminal nature of the adjudicated allegations in the "dormant" action. *Id.*

⁴⁴ 17 C.F.R. § 240.14a-9 (1985); *see* L. Loss, *supra* note 32, at 509-67.

⁴⁵ *See, e.g.,* Longstreth, *SEC Disclosure Policy Concerning Management Integrity*, 38 BUS. LAW. 1413 (1983).

⁴⁶ *See infra* text accompanying notes 210-11.

sure is made.⁴⁷ Efforts to adopt federal minimum requirements as a matter of common law have failed.⁴⁸ Efforts to scrutinize the fairness of disclosure actually made now seem limited to the large but special case of conflict-of-interests reorganizations.⁴⁹ These efforts more and more are subsumed under the general scrutiny of the fairness of the actual substantive terms proposed, as discussed below.⁵⁰

3. Agenda and Their Manipulation

The crude problems of manipulation of the meeting itself to obtain some tactical advantage over an insurgency campaign are, on the whole, adequately controlled under general common law fiduciary principles.⁵¹ Unexpected shortening of the time for calls to meetings, the major example, no longer is a serious problem.⁵² The same is true for egregious manipulation of the meeting itself.

More troubling is agenda control⁵³ with respect to shareholder resolutions and the nomination of directors. The well-known federal "shareholder proposal" rule,⁵⁴ still the haven of quixotic proposals,⁵⁵ is the easy target of narrowly conceived cost-benefit evaluations under allocative-efficiency criteria.⁵⁶ That, of course, is pitting incommensurables against each other for it has generally been accepted that the shareholder proposal is a marginal safety valve, a politically oriented corporate-legitimation device whose value is not captured simply by discussing its direct cost.⁵⁷ That cost is a major (and defensible) reason why the shareholder-propo-

⁴⁷ The only procedural escape from this position of nonreviewability lies in the plenary quo warranto action to challenge an election to office, but even these actions generally do not review the adequacy of proxy solicitation material. See R. JENNINGS & R. BUXBAUM, *supra* note 9, at 261-62.

⁴⁸ See, e.g., *Williams v. Sterling Oil, Inc.*, 267 A.2d 630, 634 (Del. Ch. 1970) (rejecting plaintiff's argument that "court should take judicial notice of the SEC and NASD rules as a minimum standard of conduct"), *rev'd on other grounds*, 273 A.2d 264 (Del. 1971). Cf. generally 2 L. LOSS, SECURITIES REGULATION 980 (2d ed. 1961) (noting the "inhospitable reception" given the federal proxy rules by a number of state courts).

⁴⁹ See *Weinberger v. UOP*, 457 A.2d 701 (Del. 1983).

⁵⁰ See *infra* text accompanying notes 220, 240-42.

⁵¹ See *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439 (Del. 1971); cf. *Jacobson v. Moskowitz*, 27 N.Y.2d 67, 71-72, 261 N.E.2d 613, 615, 313 N.Y.S.2d 684, 687 (1970).

⁵² *Schnell v. Chris-Craft Indus.*, 285 A.2d 437 (Del. 1971); cf. *Datapoint Corp. v. Plaza Sec. Co.*, 496 A.2d 1031, 1036 (Del. 1985) (invalidating bylaw as "unreasonabl[y]" delaying effective date of actions adopted via shareholder consents obtained in lieu of a meeting).

⁵³ See Levine & Plott, *Agenda Influence and Its Implications*, 63 VA. L. REV. 561 (1977).

⁵⁴ 17 C.F.R. § 240.14a-8 (1985).

⁵⁵ E.g., *Transamerica Corp.*, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,335 (SEC no-action letter) (Division of Corporate Finance promising a no-action recommendation to the SEC upon the exclusion from proxy materials of a proposal calling upon the board to adopt a resolution in support of the Jarvis-Gann tax reduction initiative because not related to the company's business).

⁵⁶ See, e.g., *Liebeler, A Proposal to Rescind the Shareholder Proposal Rule*, 18 GA. L. REV. 425 (1984).

⁵⁷ DIVISION OF CORP. FIN., SEC. EXCH. COMM'N, STAFF REPORT ON CORPORATE ACCOUNTABILITY, 96TH CONG., 2D SESS. 133 (Comm. Print 1980) (noting rule "was operating well" and generally accepted as valuable for shareholder participation).

sal rule has made no headway at the state law level, either by common law adaptation of the federal regime or by statute. On the other hand, for the publicly held company, to which the federal regime is limited, its legitimating role may make it worth retaining in spite of its costs.

4. The Nomination Process and Its Control

In contrast to the previously discussed information requirements, little has been done to regulate the nominating process. Like the disclosure requirements intended to regulate bribery, the SEC trial balloon launched during the Carter administration has all but failed, despite the fact that the SEC is on record as considering the director-nomination process to be within its enabling authority.⁵⁸ Interestingly, some states have moved towards granting nonmanagement candidates easier access to the nomination and election machinery. For now, however, this access has been confined to the slightly different situation of nonprofit corporations. For these corporations, several courts have discovered—or invented—common law rights of “fair process.” In other words, the courts have required fair starting positions for management and dissident slates as a procedural requirement inherent in the concept of membership corporations.⁵⁹

This fairness requirement has proved instrumentally difficult to adapt to the business corporation, where one share, not one member, equals one vote in the election and usually in the nomination process. To date none of the proposals for direct nomination as of right, with or without some threshold requirement based on percentage of ownership, has made any headway. We remain where the jawboning of the SEC and the New York Stock Exchange has left us: with a slight push towards the use of a separate nominating committee of the board, composed of outside directors, who ought to be open to nomination suggestions.⁶⁰

⁵⁸ Sec. Exch. Act of 1934 Release No. 13901 (Aug. 29, 1977), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,296.

⁵⁹ *E.g.*, *Braude v. Automobile Club*, 78 Cal. App. 3d 178, 182-86, 144 Cal. Rptr. 169, 171-73 (1978); *Dozier v. Automobile Club*, 69 Mich. App. 114, 244 N.W.2d 376, 381 (1976) (“[W]e do not suggest that nonmanagement candidates for the board of a nonprofit corporation must in all cases have superior or equal advantages in an electoral battle. We suggest only that nonmanagement candidates must receive treatment that is fair when compared to that accorded management candidates.”); *see also* *Durkin v. National Bank*, 772 F.2d 55, 59 (3d Cir. 1985) (holding that the voting rights assured national bank shareholders, 12 U.S.C. § 61 (1982), include the right to nominate directorial candidates).

As the nominating process circumscribes the range of the choice to be made, it is a fundamental and outcome-determinative step in the election of officeholders. To allow for voting while maintaining a closed candidate selection process thus renders the former an empty exercise. This is as true in the corporate suffrage context as it is in civic elections

Id.

⁶⁰ *See* Ferrara, *Current Issues Between Corporations and Shareholders: Federal Intervention into Corporate Governance*, 36 BUS. LAW. 759, 762 (1981).

B. The Exclusion of Shareholders from Decisionmaking

Perhaps more important than the limitations on information are the restrictions on shareholder participation itself. The central theme of this Article is the substantial erosion of shareholder participation in structural decisions affecting the fate of their investments. To some degree the legislatures are responsible, but to a far greater degree it is the courts that are relegating shareholders to the questionable role of bystanders. Shareholders frequently have been left with exercising merely ceremonial functions in decisions affecting not only corporate operations but also the central owner-enterprise relationship itself. In many instances, courts have limited or eliminated the shareholders' ultimate authority over structural decisions via an expanded definition of "business judgment." This part critically explores this development in four separate contexts: 1) the elimination, by contract and statutory interpretation, of the role of preferred shareholders in corporate reorganizations; 2) the limitation of the right of common shareholders to vote on a variety of merger-related transactions; 3) the approval of hostile-takeover defensive tactics that give management the discretionary right to trigger supermajority shareholder vote requirements; and 4) the approval of managerial commitments to third parties to disregard possible shareholder acceptance of statutory merger proposals.

To begin this review with the treatment of preferred stock may seem out of sequence; it is the treatment of voting stock in major structural transactions that underlies current debates about the division of powers between management and shareholders. On the other hand, what has happened to the explicitly contractual rights and attributes of preferred stock foreshadows the disenfranchisement dangers facing common stock in statutory-merger and takeover-bid situations. Preferred stock is in this sense a bellwether for all stock, voting as well as nonvoting. A description and critique of recent judicial treatment of the participation claims of preferred shareholders will clarify the frame of reference for the later discussion of analogous developments in the common stock area.

1. Stock Classes and Their Relation to Participation Rights

The first problem in the panoply of issues relating to shareholder participation in structural decisions arises from the categorization of shareholders on the basis of stock class and series. If enterprise-financing plans call for a more differentiated structure than simply issuing shares representing residual rights to profit and return of capital, legislatures and courts need to address governance and financial rights of the new elements of the stock structure. Corporate governance issues affecting preferred stockholders are a convenient focal point for this discussion.

Preferred stock comes in many guises, and no single Platonic form

underlies its variety.⁶¹ Whatever its attributes (its “rights, preferences, and privileges,” in the jargon), preferred stock is quintessentially a matter of contract. If any deviation from the attributes of the residual common stock concept is desired, the contract must specify it. Of course this is only an imaginary situation. Preferred stock not only needs to be defined by contract, it is defined by contract—by definition, one is tempted to say.⁶² Even so, the potentially problematical diminution of preferred shareholder participation in corporate governance stems not from the fact that participation is almost totally a matter of contract, but from the courts’ occasionally dubious approach to contract interpretation, especially in the shadow of the partial but incomplete regulation of some participation rights by statute.

a. The Example of a New Issuance

A related problem is the issuance of new preferred stock that can affect current shareholders’ interests. Typically the shareholders have no decisionmaking power as to the issuance of specific preferred stock.⁶³ This is not inevitable but rather arises from the historical invention and judicial acceptance of the concept of issuing preferred stock in separate series within a single umbrella class.⁶⁴ The shareholders authorize the class in the articles of incorporation by a pro forma, boilerplate enabling provision. It is authorized completely without attributes, as a “blank stock”—today a term of art.⁶⁵

The justification for this approach was originally and remains the instrumental need for flexibility. Such stock, limited in its financial returns to a set or at least a capped amount, must compete in financial markets. Thus, it must be priced with exogenous as well as firm-endogenous factors in mind. It cannot simply be issued at a price determined by a preordained relation to the going prices for the firm’s residual stock.⁶⁶ Because of practical constraints, this flexibility is inconsistent with a requirement for shareholder approval of stock issuance in all but the smallest corporation. Director approval heretofore was considered appropriate for specific issuance in series form. The only shareholders who do participate in stock issuance are the holders of previously issued preferred shares, and then usually only if those shares are materially af-

⁶¹ See Buxbaum, *supra* note 16, at 298-306.

⁶² The board of directors writes (or, in the case of the placement of entire classes of stock with institutional investors, negotiates) this contract.

⁶³ The exception is the special case of private placement of stock with institutional investors.

⁶⁴ See Loomis, *Corporation Code Amendments*, 23 S. CAL. L. REV. 12, 13 (1949).

⁶⁵ E.g., CAL. CORP. CODE §§ 202(e), 401(c) (West 1977 & Supp. 1985); N.Y. BUS. CORP. LAW § 5:02 (McKinney 1965); PA. CONS. STAT. ANN. § 1601 (Purdon 1967 & Supp. 1985).

⁶⁶ Indeed, financial analysts consider preferred stock more analogous to debt than equity in the spectrum of corporate capitalization. See S. COTTLE, D. DODD & B. GRAHAM, *SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES* 375 (4th ed. 1962).

fects by the new issue.⁶⁷

At present the protection of the preferred shareholders' interests is inadequate. As section 10.04 of the revised Model Act indicates,⁶⁸ the protection is triggered only by a stock issue that requires the amendment of the articles of incorporation. In that case, section 10.04(a)(6) provides a present class the right to class-specific, though majoritarian, approval. Subsection (b) increases the protection by providing series-specific approval rights, if the new class would affect existing series differently. All that is fine, but irrelevant so long as new stock can be issued by the directors alone, without amendment of the articles, by being nominated a "series" of an already blankly authorized class.⁶⁹ Although the new series may detrimentally affect an existing class or series, those preferred shareholders would have no protection.

The manipulative possibilities created by this class/series distinction are well-illustrated in *Terry v. Penn Central Corp.*,⁷⁰ though on the background facts of that case it is hard to feel sorry for the well-represented recipients of the First Series stock issued in exchange for their Marathon holdings. Terry and others in his situation received all issued shares of a First Series Preference Stock on the merger of their company, Marathon, into a subsidiary of Penn Central, which was the first step in the latter's plan to acquire companies for tax-loss sheltering benefits. Plaintiffs objected to the later-proposed acquisition of Colt Industries by merger, for which a Second Series Preference Shares, "not . . . superior in any way to the Preference shares generally,"⁷¹ were to be issued. They claimed a contractual right to a separate class—actually, series—vote on that transaction. Penn Central's Amended Articles of Incorporation specified that no class vote or consent was required for the issuance of any shares of any class or series "subordinate to shares of First Series Preference Stock."⁷²

The facts of this case, combined with the contract mentality under-

⁶⁷ CAL. CORP. CODE § 903 (West 1977).

⁶⁸ MODEL BUS. CORP. ACT ANN. § 10.04 (1985).

⁶⁹ At first glance, § 903 of the California Corporations Code does provide some protection in this case: "Different series of the same class shall not constitute different classes for the purpose of voting by classes except when a series is adversely affected by an amendment in a different manner than other shares of the same class." CAL. CORP. CODE § 903(b) (West 1977). Again, however, note that this voting right is not triggered except by an "amendment" of the articles of incorporation. As stated in the text, the issuance of a new series of stock by the directors, though perhaps affecting the rights of a prior, outstanding series, can be affected without an amendment. Thus, the section has no basis for application in the first place.

⁷⁰ 668 F.2d 188 (3d Cir. 1981), *aff'g* 527 F. Supp. 118 (E.D. Pa. 1981).

⁷¹ *Terry*, 668 F.2d at 191.

⁷² *Id.* at 191-92 & n.4 (quoting the amended articles). The court stated that the only other "arguably relevant" provision in the articles was one requiring a separate vote for any transaction which would "adversely affect [only] the First Series Preference Stock." *Id.* at 191 (quoting the amended articles). The court rejected a claim under this provision that the First Series alone was harmed by the Second Series's "superior" voting rights, upholding the lower court's finding that the Second Series had no rights superior to those of the First Series. *Id.* at 192.

lying the trial and appellate opinions, foreclosed any resolution other than a denial of voting rights. The trial court found that proposed language to extend the vote to an issuance of subsequent series of equivalent preference stock had been rejected by Penn Central during the negotiations with Marathon.⁷³ Under these circumstances, the Third Circuit Court of Appeals readily held that the contract's explicit denial of voting rights only upon the issuance of subordinate shares did not permit the negative inference that voting rights were required upon the issuance of equivalent shares.

Looked at slightly more abstractly, however, the court's opinion is less than satisfying. The flexibility rationale does not justify the issuance of separate preferred stock series for subsequent major transactions, such as the proposed Colt acquisition, without permitting the prior series's holders to participate in that decision. Ordinary shareholders of Marathon, who had voted for the statutory merger of that company into Penn Central but were not privy to the Marathon management's negotiations of those terms, might be forgiven for having assumed that their participation in later decisions such as the Colt acquisition was assured. The argument accepted by the court, that "equal" does not imply voting rights any more than does "subordinate" under the terms of the Amended Articles, might be acceptable against their drafter, but it is hard to see why it should be thrown against the ex-Marathon shareholders in the abstract. Certainly, the arrival of additional preferred shareholders of equal status could threaten the First Series's dividend and liquidity margins, depending on the value of the newly acquired subsidiary.⁷⁴ A merger resulting in the issuance of such equivalent preferred shares, as opposed to common stock,⁷⁵ affects financial interests of existing preferred shareholders, and thus they have an interest in such corporate decisions.⁷⁶ I repeat, however, that the court's findings on the apparently sophisticated negoti-

⁷³ *Terry*, 527 F. Supp. 118, 128 (E.D. Pa.), *aff'd*, 668 F.2d 188, 192 (3d Cir. 1981).

⁷⁴ The trial court recognized this possibility, but dismissed plaintiff's expert testimony and tests of economic disadvantage to the First Series as "ultimately nothing but ground for saying that the economic picture is less good *post* the transaction than *pre* for those in plaintiffs' series." *Terry*, 527 F. Supp. at 126 (emphasis in original). Although the court correctly framed the issue as the effect on "the protections that plaintiffs are entitled to with respect to their protected dividend position," *id.*, it erred in dismissing the issue by reasoning that "the possibility of default by Penn Central, if there be any, is a long, long, long way from now," *id.* at 127. By this logic, preferred shareholders of a financially strong corporation need not have voting rights regarding the issuance of *superior* preferred shares, because the possibility of default on dividends or bankruptcy would be very slight.

The case incidentally provides an object lesson on the need to consider the acquiror's ability to avoid its (common) participation in successive structural transactions, individually below the level of mergers but collectively transforming the company. See M. EISENBERG, *supra* note 1, at 291-92; Yarrow, *Shareholder Protection, Compulsory Acquisition and the Efficiency of the Takeover Process*, 34 J. INDUS. ECON. 3, 16 (1985).

⁷⁵ See 2 H. MARSH, *supra* note 1, § 18.20, at 517.

⁷⁶ See *infra* text accompanying notes 77-95.

ations between Marathon representatives and Penn Central are another matter and probably justify the outcome of the case.

b. The Reorganization Situation

Another interesting recent case which, similar to *Terry*, is contractarian to a fault illustrates the erosion of the right of preferred shareholders of a target company to participate in the corporate reorganization. The unreported case of *Woods v. Natomas Co.*⁷⁷ involved the preferred stockholders' right to vote separately on a proposed merger of Natomas into Diamond Shamrock Corporation. The transaction was structured in the form of two reverse (or "phantom") triangular mergers.⁷⁸ The new holding company, "New Diamond," arose from a merger of N-Sub, Inc., the subsidiary of New Diamond created solely to effect the merger, into Natomas. Upon their affirmative vote, Natomas's common shareholders had their stock converted into New Diamond stock, and N-Sub, Inc. converted its shares of New Diamond into the issued and outstanding shares of Natomas. Thus, Natomas common shareholders became shareholders in New Diamond, and New Diamond became the sole Natomas common shareholder. The same arrangement was carried out by Diamond Shamrock. The proportion of New Diamond shares owned by the former common shareholders of the two firms reflected the respective market values of each. As a result, the former Diamond Shamrock shareholders became the majority owners of New Diamond.

Natomas Corporation was the survivor in its reverse triangular merger, remaining intact as a wholly owned subsidiary of New Diamond. The preferred shareholders of Natomas continued to be Natomas preferred shareholders, and their rights, preferences, and privileges as set forth in the original Certificate of Determination were not altered in any formal sense. On the other hand, since Natomas common stock was to be delisted, Natomas preferred shareholders were to lose access to a public market. Such access formerly had been available because of the shareholders' right to convert their shares into common stock. After the merger, were the preferred shareholders to convert their shares to common stock, they would have been the only owners of (delisted) Natomas common stock other than New Diamond—and owners of a minuscule fraction of the stock at that.⁷⁹ Thus, the conversion rights of holders of

⁷⁷ No. 811-238 (San Francisco Super. Ct. Aug. 1, 1983) (denying preliminary injunction against merger). Appeals from an order of summary judgment for defendant, dated August 10, 1985, are pending in *Woods*, No. A-029977 (Cal. Ct. App. Dist. 1 Div. 3), and a consolidated companion case, *Kirschner Bros. Oil, Inc. v. Natomas Co.*, No. A-030416 (Cal. Ct. App. Dist. 1 Div. 3).

⁷⁸ For an explanation of this type of merger, see 2 H. MARSH, *supra* note 1, § 18.9, at 493-94.

⁷⁹ See the often-cited if little-used case of *United Funds, Inc. v. Carter Prods., Inc.*, [1961-1964 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,288 (Baltimore City Cir. Ct. 1963). *But cf.* Recent Case, 77 HARV. L. REV. 757 (1964) (criticizing *United Funds* as too disruptive of managerial decisionmaking).

Natomas preferred stock were undermined, being “preserved” only in a formal sense, especially since the directors could have set the exchange rate for the new preferred stock.

The Natomas preferred shareholders’ effort to obtain voting rights under California law failed. While section 1201(a)⁸⁰ of the Corporations Code grants each class of each involved corporation the right to vote on reorganizations (including reverse triangular mergers), it goes on to state that “no approval of any class of outstanding preferred shares of the surviving or acquiring corporation or parent party shall be required if the rights, preferences, privileges and restrictions granted to or imposed upon such class of shares remain unchanged.”⁸¹

The technical issue, whether “surviving or acquiring” properly fit Natomas, was decided against the plaintiffs.

Despite the fact that a forward triangular merger . . . could not have occurred without the approval of the Natomas preferred shareholders, holding there to be no requirement for such approval in the case of a reverse merger . . . does not elevate form over substance. Without questioning that both colloquially and for various purposes (such as accounting purposes), Diamond Shamrock is indeed the “acquiring” partner in the proposed reorganization regardless of the direction of the merger, there is still substance to the designation of Natomas as the surviving corporation . . . in the overall reorganization. Because the reverse form will be used, Natomas will remain as a legal entity.⁸²

This passage addresses and disposes of the “sham transaction” issue, but whether preferred shareholders should have the vote rests on a different or at least larger point: the application of the *de facto* merger doctrine to the special case of preferred stock. From this perspective the opinion is less satisfactory. It is true that the court entertained the question whether “some circumstances beyond the terms of the Certificate of Determination may affect [the preferred stock],”⁸³ but it saw as relevant to that question only the disappearance of the public market for the continuing preferred and common shares of Natomas (the latter including both those thereafter to be owned by New Diamond and those which after conversion of the continuing Natomas’s preferred would be issued to those holders). Arguing that the statute protected only those rights granted the preferred stockholders by contract, the court then failed actually to review that contract, and especially its potential reliance on statutory protection. Instead, it simply concluded that preferred shareholders had no general right to the continuing existence of a public market for preferred shares.⁸⁴

The court accepted as a limit on the reorganization plan only a fidu-

⁸⁰ CAL. CORP. CODE § 1201(a) (West Supp. 1985).

⁸¹ *Id.* This provision is discussed in 2 H. MARSH, *supra* note 1, § 18.20, at 516-18.

⁸² *Woods*, slip op. at 4.

⁸³ *Id.*, slip op. at 5.

⁸⁴ *Id.*, slip op. at 6-7.

ciary obligation not to destroy the market for issued shares “capriciously.” Then, after assuming that the separate business purpose for structuring the transaction in this reverse triangular fashion might not justify depriving preferred shareholders of a public market, it reviewed the plan’s grant of an exchange right (which gave Natomas preferred holders “equivalent” New Diamond preferred stock) exercisable only on a majority vote of the class. Finding this alternative adequate, the court reasoned:

The New Diamond preferred unquestionably will have a public market and will be convertible into shares of New Diamond common which also will be publicly traded. Importantly, there is no suggestion that the rights [attached to this new preferred stock] will be more limited . . . than those which presently accompany the Natomas preferred shares. . . . True, their right to convert will in that event be to convert into shares of a corporation controlled by different shareholders and . . . management, but their present holdings . . . do not give them the right to approve either those who own or those who manage the corporation.⁸⁵

This is too narrowly conceived an “economic equivalence” argument to satisfy the purposes of the de facto merger doctrine which, it is generally agreed, California has by statute accepted at least as a general guideline,⁸⁶ and, as its treatment of the forward triangular merger demonstrates, has separately extended to the benefit of preferred stock.⁸⁷ The policy justification for the doctrine generally lies in the legislative con-

⁸⁵ *Id.*, slip op. at 8-9. Interestingly, the technical survival of Natomas was one reason for judicial acceptance of the right of a former common stockholder of Natomas to continue prosecuting her derivative action challenging golden parachutes provided for in the merger agreement. *Gaillard v. Natomas Co.*, 173 Cal. App. 3d 410, 418, 219 Cal. Rptr. 74, 79 (1985).

⁸⁶ That is the clear consequence of the formulation of voting rights provided in CAL. CORP. CODE § 1201 (b)-(d) (West Supp. 1985). See Small, *Corporate Combinations Under the New California General Corporation Law*, 23 UCLA L. REV. 1190, 1225 n.166 (1976) (confirming that this was the legislative intention, citing a 1975 report of the California Assembly Select Committee on the Revision of the Corporations Code).

⁸⁷ Demonstration that this logical conclusion is in any event immanent in the statutory text is possible, though it requires a close textual analysis of § 1201. CAL. CORP. CODE § 1201 (West Supp. 1985). Section 1201(a) grants the preferred shareholders of the target (disappearing) corporation the right to vote. If, however, their company’s common voting stock ends up with more than five-sixths of the combined entity’s voting stock, § 1201(b) deprives both the common and the preferred stock of the right to vote. That is the classic upside-down merger, in two-party or reverse-triangular form, but looked at from the perspective of the disappearing whale, not the surviving minnow. Even in this situation, however, the whale’s preferred stock, though not the common stock, is granted the right to vote pursuant to § 1201(d), if the new preferred stock to be received from the surviving but whale-controlled minnow possesses different attributes than those the old preferred stock enjoyed.

What then, of the preferred shareholders of the surviving minnow in this limiting case of the upside-down (two-party or triangular) merger? Their economic rights are affected by the transaction just as they would be by a normal (not upside-down) two-party or a normal (forward) triangular merger. Since, as *Woods* explicitly recognizes, § 1201(a) only disenfranchises the preferred shareholders of the surviving corporation, *Woods*, slip op. at 3-4, the preferred shareholders in the former cases would have the vote. And they would have the vote though the actual attributes of the new

cern that the economic consequences of the consolidation of stockholders' ownership positions in a new, combined entity can be sufficiently serious to justify shareholder participation in a merger-equivalence decision.⁸⁸

As an original proposition, the extension of this rationale and thus of the de facto merger doctrine to preferred stock might be debated. Given the limited residual claim of preferred stock to corporate assets, and its concomitantly limited exposure to risk, only the risk that the new, combined entity's financial position has eroded or endangered the preferred stock's "cushion" would be relevant to that stock's right to participate in the merger decision.⁸⁹ But the fact of the matter is that the statute does extend the de facto merger doctrine to preferred stock exactly in that less exiguous situation. After all, the only justification for the section 1201(a) grant of a class vote to preferred stock of the disappearing company in a forward triangular merger is that weaker version of the basic economic rationale of the doctrine. The *Woods* court's conclusory dismissal of the possibility of economic detriment in this situation cannot be reconciled with this legislative policy.⁹⁰

Whether the case also bodes ill for the far more significant economic expectations of common stock owners that are protected by the de facto

preferred stock to be received were identical with those of the old stock. At first glance it thus does seem that the statute treats two identical cases in disparate fashion.

To resolve this seeming disparity while honoring the literal language of § 1201(a), it is necessary to look at the exact conditions under which this section deprives the surviving entity's preferred shareholders of their class vote. This disenfranchisement occurs only if two independent conditions are met. The first condition is innocent and appropriate, and can be put aside: The transaction may not be accompanied by an amendment of the articles on a matter as to which the preferred stock would normally vote (see the cross-reference to § 1201(c)). The second condition, which is the key to the appropriate construction of the statute, is that the rights "granted to or imposed upon" the preferred stock—*other than by means of an amendment of the articles*—shall remain unchanged.

This second condition can be read to include the economic changes, affecting these rights, that result from any merger other than a trivial one (i.e., one falling under the five-sixths exception contained in § 1201(b)). This textual analysis confirms the legislature's policy decision to extend the protection of the de facto merger doctrine to preferred stock so far as appropriate and confirms the common sense view that this extension applies also to the situation at issue in *Woods*, as to which the decision incorrectly denies coverage.

The condition also might apply to a new series of preferred stock which, though issued under the "blank stock" authority delegated to the board, see *supra* text accompanying notes 63-65, economically "affected" the earlier-issued series or classes of preferred stock of a nominally surviving corporation. This reading, however, is neither exclusive nor inconsistent with the first.

⁸⁸ Marsh assumes that consolidation can only be beneficial in economic terms, 2 H. MARSH, *supra* note 1, § 18.20, at 517, but discusses only later issuance of junior stock, see *infra* note 93.

⁸⁹ See CAL. CORP. CODE § 1201(b) (West Supp. 1985).

⁹⁰ See *infra* note 93. It should also be noted that preferred shareholders have no dissenters' appraisal alternative because this usually is only available to those who do have a right to participate in the questioned decision. See *In re Harwitz*, 192 Misc. 91, 93-94, 80 N.Y.S.2d 570, 572-73 (N.Y. Sup. Ct. 1948) (right of appraisal limited to those "entitled to vote" on sale-of-assets transaction); see also Pittman, *Corporations—Are Nonvoting Shares Entitled to Appraisal Rights?*, 28 MO. L. REV. 246 (1963) (arguing that, absent legislative intent to the contrary, appraisal statutes applying to shares not voted in favor of merger do not give remedy to nonvoting shares); cf. *Woodward v. Quigley*, 257

merger doctrine⁹¹ is hard to say because it is hard to conceive of a merger transaction that could nominally avoid that stock's voting rights by shaping the deal in a manner analogous to that invented in *Woods*.

In any event, these decisions reflect an unmistakable indifference to the role accorded preferred shareholders in major structural decisions. The *Woods* court probably identified the underlying reason for this view when it stated its concern that the "right [to disapprove the transaction] could be used for the unjustifiable purpose of negotiating improved benefits to which the preferred shareholders are not entitled."⁹²

Preferred shareholders' participation is only "unjustifiable," however, if they have no interests at stake.⁹³ These preferred shareholders seem to have a legitimate interest however, when a transaction results in the addition of competing, equal claimants, who by their very presence reduce the margin of financial protection previously enjoyed by the target company's preferred shareholders. Undoubtedly, interests requiring "justifiable" participation are at stake when the value of a preferred stock can be substantially eroded or its rights changed despite its "bargained-for" nonvoting status. Therefore, rather than viewing nonvoting status as the end of the inquiry, courts should require preferred shareholder

Iowa 1077, 1086, 133 N.W.2d 38, 43 (1965) (appraisal remedy enacted to protect minority when common law requirement of unanimity replaced by statutory provisions for majority vote).

An appraisal in any event would be difficult since the only issue given the fixed nature of the preferred's value is the contingency, which is by definition uncertain, that these values might be in jeopardy as a result of the proposed transaction.

The recent case of *Rothschild Int'l Corp. v. Liggett Group, Inc.*, 463 A.2d 642 (Del. Ch. 1983), *aff'd*, 474 A.2d 133 (Del. 1984), typifies a related situation, wherein preferred stockholders were not accorded effective means to protect their class interests. By the terms of Liggett's charter, the holders of its 7% Preferred had no separate class voting rights. Although less than forty percent of these holders had tendered their stock in response to the tender offer, the overwhelming majority of the two other classes had tendered their stock. (The proportional payment offered the other classes was substantially more favorable than that offered the 7% Preferred.) The acquiring corporation was able to outvote the 7% Preferred holders at the merger stage and force upon them the previously tendered and rejected cash-merger offer. Denial of a class vote effectively prevented the holders of 7% Preferred from enforcing a joint decision not to tender their shares for the proffered consideration.

⁹¹ For that justification, see *Applestein v. United Bd. & Carton Corp.*, 60 N.J. Super. 333, 159 A.2d 146 (1960), *aff'd per curiam*, 33 N.J. 72, 161 A.2d 474 (1960). Cf. M. EISENBERG, *supra* note 1, at 218-23 (discussing de facto merger doctrine).

⁹² No. 811-238, slip op. at 4. But cf. *Cohn v. Crocker Nat'l Corp.*, 490 A.2d 569 (Del. Ch. 1985) (preferred stockholders had compromisable good faith dispute over whether they had the right to vote on a merger due to its effects on their conversion rights).

⁹³ 2 H. MARSH, *supra* note 1, § 18.20, at 517. The court in *Woods* relied on Marsh to support a finding that participation by preferred shareholders was unjustifiable. *Woods*, slip op. at 4. Marsh, however, restricts the argument that preferred shareholders could extract unjustified benefits to situations in which junior preferred stock or common stock are later issued; there a merger of the corporation with another normally produces no prejudice to the senior preferred shareholders. "[T]he existing preferred stock of the acquiring corporation can only be benefited by the transaction, which results in an increase in the assets and net worth protecting their preferences." 2 H. MARSH, *supra* note 1, § 18.20, at 517.

participation when structural changes would affect the preferred shareholders' status as priority claimants to residual (equity) assets.

Fortunately, the recent case of *Shidler v. All American Life & Financial Corp.*⁹⁴ is a refreshing reminder that, through its reserved power, the judiciary can adapt to particular circumstances by interpreting a general statutory enjoiner to consider shareholder participation rights as the norm, with some exceptions. The Iowa Supreme Court interpreted a state statute's requirement that a class of shareholders approve a cancellation of shares on a class basis to apply to cash merger transactions. Indeed, in *Shidler* the statute, which provided voting rights to any class whose shares would be cancelled in a reorganization, superseded the bargained-for article provisions purporting to merge the classes into one class for voting purposes.⁹⁵

This resolution of a recurrent tension between statutory and contractual treatment of shareholder participation rights recalls and confirms the earlier suggestion that underlying judicial attitudes towards the "proper" place of the preferred shareholder in the owner-manager hierarchy determine the judicial approach to these so-called "interpretation" questions. The particular results are always defensible, but the overall disenfranchising trend is clearly discernible. That trend is thrown into even sharper relief by the occasional cross-grained case like *Shidler*, whose congruence with modern contract law tendencies is as notable as is its incongruence with the contrary *Terry-Woods* line of decisions.

2. Contractual Limitations on Voting Power

A second problem of shareholder participation arises from contractual attempts to limit either the ownership rights or the voting power of a particular, large shareholder or a specifically identified category of shareholders.⁹⁶ The problem often has been discussed in Europe,⁹⁷ and in

⁹⁴ 298 N.W.2d 318 (Iowa 1980). This issue was certified to the state court by the federal court before which a conversion action by the complainants was pending. The federal circuit court now has ruled that the violation of Iowa law, as interpreted by *Shidler*, supported a private action for damages. *Shidler v. All Am. Life & Fin. Corp.*, 775 F.2d 917 (8th Cir. 1985).

⁹⁵ *Id.* at 324. The provision for class voting in this case contrasts starkly with the judicial deference to contractual limitations on the participation rights of the 7% Preferred holders as a class in *Rothschild Int'l Corp. v. Liggett Group, Inc.*, 463 A.2d 642 (Del. Ch. 1983), *aff'd*, 474 A.2d 133 (Del. 1984). See *supra* note 90.

⁹⁶ See Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote"*, 56 CORNELL L. REV. 1 (1970) (historical and comparative discussion of controls on the voting power of large shareholders and their implications for takeover bids and efficient management).

⁹⁷ See, e.g., Arnold, *Defences to Takeovers: Switzerland*, 8 INT'L BUS. LAW. 41, 42-43 (1980) (corporations may refuse to register new owners of registered shares if articles of incorporation provide grounds for doing so); Lutter & Schneider, *Die Beteiligung von Ausländern an inländischen Aktiengesellschaften—Möglichkeiten der Beschränkung nach geltendem Recht und Vorschläge de lege ferenda*, 4 ZEITSCHRIFT FÜR UNTERNEHMENS- UND GESELLSCHAFTSRECHT 182, 193-95 (1975) (voting limitations can hinder the building of foreign majorities, though this result may be circumvented by devices such as shareholders' voting agreements).

more explicitly political terms in Canada,⁹⁸ but only recently has the discussion surfaced in the United States.⁹⁹ The fear of literal "alienation" lies behind these efforts. At least in the United States the legitimacy of such restrictions is still open to question.

An important bellwether on this issue is *Providence & Worcester Co. v. Baker*,¹⁰⁰ which upheld such a voting restriction in a certificate of incorporation under Delaware law. The provision allocated one vote for each twenty shares owned after the first fifty shares, and prohibited a stockholder from voting more than one-quarter of the shares issued and outstanding, unless as proxy for others.¹⁰¹ As a result, the plaintiff, who was the largest shareholder, had twenty-eight percent of the shares yet only three percent of the voting power.¹⁰² The state supreme court, in an opinion startling in its literalness even for Delaware, held that the statutory requirement of class-level equality in the statement of a stock's rights, preferences and privileges did not forbid these restrictions. It reasoned that the restrictions were "limitations upon the voting rights of the stockholder, not variations in the voting powers of the stock per se."¹⁰³

Some jurisdictions rely on specific statutory grants of authority to allow similar restrictions. For example, some states explicitly permit the articles to specify necessary or forbidden attributes of share ownership by persons or types of persons.¹⁰⁴ Such a restriction might well fail if found suspect on classical constitutional grounds such as race or gender.¹⁰⁵

⁹⁸ See GOVERNMENT OF CANADA, FOREIGN DIRECT INVESTMENT IN CANADA 320-21, 323, 327-28 (1971) ("Gray Report") (discussing various Canadian restrictions on transfers of shares to nonresidents); TASK FORCE ON THE STRUCTURE OF CANADIAN INDUSTRY, FOREIGN OWNERSHIP AND THE STRUCTURE OF CANADIAN INDUSTRY 24-25, 302, 395-414 (1968) ("Watkins Report") (expressing concern over foreign control of Canadian corporations and discussing proposals to counter this development). For a review of the legislative and administrative experience during the era of active implementation of these restrictions, see Comment, *Foreign Investment Restrictions: Defending Economic Sovereignty in Canada and Australia*, 14 HARV. INT'L L.J. 345 (1973).

⁹⁹ See *Joseph E. Seagram & Sons v. Conoco, Inc.*, 519 F. Supp. 506 (D. Del. 1981) (corporate bylaw barring sale of stock to aliens could not apply to shares issued prior to its adoption, absent agreement by holders of those shares).

¹⁰⁰ 378 A.2d 121 (Del. 1977).

¹⁰¹ *Id.* at 121 n.2.

¹⁰² The specifics of the voting restriction are discussed in the lower court's opinion, *Baker v. Providence & Worcester Co.*, 364 A.2d 838, 840-41 (Del. Ch. 1976), *rev'd*, 378 A.2d 121 (Del. 1977).

¹⁰³ *Providence & Worcester*, 378 A.2d at 123 (emphasis in original). The court justified this conclusion by reasoning that the same shares held by a small stockholder would not have these limitations.

¹⁰⁴ *E.g.*, DEL. CODE ANN. tit. 8, § 202 (1983) (upholding a prohibition on "the transfer of the restricted securities to designated persons or classes of persons, [if] such designation is not manifestly unreasonable"). As CAL CORP. CODE § 402(c)(3) (West 1977) intimates, direct restrictions on ownership traditionally are found only in the articles of professional corporations. See, e.g., CAL. CORP. CODE § 13406 (West 1977) ("Shares of capital stock in a professional corporation may be issued only to a licensed person, and any shares issued in violation of this restriction shall be void.").

¹⁰⁵ In *In re Mather's Estate*, 410 Pa. 361, 189 A.2d 586 (1963), the court upheld a transfer restriction on shares of a family corporation that required the deceased owner's estate to sell the shares back to the family. The court noted in dictum: "More recently the principle [that unreasona-

Alienage, however, probably is not such a suspect category,¹⁰⁶ and articles prohibiting ownership of registered stock by aliens, or limiting their aggregate holdings, might well pass muster under at least explicit state statutes.¹⁰⁷

A few companies recently have adapted this approach to serve as one weapon in the arsenal of antitakeover defenses. They have obtained shareholder approval for charter provisions denying voting rights to ordinary common stock for the first few years after its purchase. This is one of the few "showstopper" defenses, and, as such, will be evaluated along with the two-class common stock or restricted-common-stock phenomenon discussed below in Section C.

3. The Shift of Voting Power from Shareholders to the Board

A more practical and equally interesting problem is the role of article provisions, adopted by shareholders, that transfer significant voting power to the board of directors. Specifically, such provisions often authorize the board to decide whether to put into play a contingently authorized supermajority-vote requirement for a later shareholder vote on a hostile merger proposal.¹⁰⁸ This is both one of the less appealing and, luckily, less effective weapons in the shark repellent arsenal of target companies. It effects a shift in voting power which undermines the level of shareholder participation in corporate governance that is essential to corporation law. This is true whether participation is viewed from an economic efficiency or constitutionalist perspective.

Shareholder participation is important in the economic model, which postulates a takeover market for control of the corporation, including proxy fights, mergers, and tender offers. A properly functioning "market for voice," which in turn is predicated upon effective shareholders' voting rights in a merger or takeover context, is an essential underpinning of the entire efficiency-monitoring concept. The economic rationale, however, assumes that the market for voice is separate from the market for exit through a stock exchange or other share market. It is a necessary condition of the economic rationale that these two markets be separable because each provides an independent monitoring system.¹⁰⁹

ble restraints on alienation will not be honored by courts] has been applied, on Constitutional grounds, to restraints on alienation to persons except those of the Caucasian race." *Id.* at 371-72, 189 A.2d at 591 (citations omitted).

¹⁰⁶ See *Ambach v. Norwick*, 441 U.S. 68 (1979).

¹⁰⁷ Nevertheless, such prohibitions may engender negative commerce clause problems. Cf. *Edgar v. MITE Corp.*, 457 U.S. 624 (1982) (Illinois act requiring advance notification of tender offer and restricting communication from offeror to shareholders held unconstitutionally to burden interstate commerce).

¹⁰⁸ See A.B.A. Comm. on Corporate Laws, *Changes in the Model Business Corporation Act—Amendment Respecting Increases in Proportion of Vote for Shareholder Approval*, 36 BUS. LAW. 1899 (1981).

¹⁰⁹ See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1171, 1173 (1981).

Thus, like a standard contract, participation helps to define the division of powers within the corporation and to provide clear lines between risk-bearing functions of principals and the representative functions of agents.

The maintenance of shareholders' voting rights in a merger or take-over context also is fundamental, in a fairly self-evident way, to the constitutionalist view of corporation law.¹¹⁰ The constitutionalist model (paraphrased here from Professor Eisenberg) derives from the typical close corporation setting four criteria for assigning responsibilities to managers or shareholders: 1) the business versus investment character of the pending decision; 2) its economic significance (magnitude, risk, timespan of consequences, reversal cost); 3) the frequency of such a decision's occurrence; and 4) its urgency.¹¹¹ This model then is extended to the publicly held company with only two modifications: all business (as opposed to investment or financial) decisions, no matter how extraordinary, are left to management, and private contractual variation is not permitted to vary statutory decisionmaking rules.¹¹²

Most shareholders are passive investors seeking liquid holdings. They have little interest in managing the firm and less incentive to learn the details of management. No one shareholder can collect all or even a little of the gain available from monitoring the firm's managers. The benefits would be dispersed among all stockholders according to their investments, not according to their monitoring efforts. Because other shareholders take a free ride on any one shareholder's monitoring, each shareholder finds it in his self-interest to be passive. He simply sells his shares if he is dissatisfied. . . .

. . . .
Tender offers are a method of monitoring the work of management teams. . . . When the difference between the market price of a firm's share and the price those shares might have under different circumstances becomes too great, an outsider can profit by buying the firm and improving its management. The outsider reduces the free riding problem because it owns a majority of the shares. The source of the premium is the reduction in agency costs, which makes the firm's assets worth more in the hands of the acquirer than they were worth in the hands of the firms' managers.

Id.

¹¹⁰ "At common law, a corporation was not required to have a board. All corporate powers were vested in the shareholders, acting by a majority, except insofar as they were explicitly delegated to management." M. EISENBERG, *supra* note 1, at 87. The following passage from an Australian decision illustrates the constitutionalism rationale:

"The constitution of a limited company normally provides for directors, with powers of management and shareholders, with defined voting powers having power to appoint the directors, and to take, in general meeting, by majority vote, decisions on matters not reserved for management. Just as it is established that directors, within their management powers, may take decisions against the wishes of the majority of shareholders . . . so it must be unconstitutional for directors to use their fiduciary powers over the shares in the company purely for the purpose of destroying an existing majority, or creating a new majority which did not previously exist. To do so is to interfere with that element of the company's constitution which is separate from and set against their powers."

Id. at 91 (quoting *Howard Smith Ltd. v. Ampol Petroleum Ltd.*, 3 Austl. L.R. 448, 457 (1974)).

¹¹¹ M. EISENBERG, *supra* note 1, at 13.

¹¹² *Id.* at 68. For Eisenberg's demonstration of the reasons for these formulations, which is sufficiently well known that I do not believe it necessary to recapitulate it here, see *id.* at 30-68. The second criterion is consistent with a view of the appropriate standardized rules for shareholder vot-

Despite the critical role of shareholders' voting rights that are independent from managerial rights under either the economic rationale or constitutionalist views, courts have applied the rules of corporation law in a way that confounds the proponents of both views.¹¹³ Legislatures and courts show a failure of nerve in their weakening resistance to corporate devices that effectively undercut shareholder voting rights. A close look at two cases—*Seibert v. Milton Bradley Co.*¹¹⁴ and *Jewel Companies v. Pay Less Drug Stores Northwest*¹¹⁵—supports this contention.

In *Seibert* the court upheld a shareholder-adopted bylaw amendment requiring approval of a merger by a seventy-five percent vote of the common shareholders, except in the case of a merger proposal first approved by two-thirds of the "incumbent" board.¹¹⁶ This gambit indirectly permits the incumbent directors of a target company to require the higher shareholder vote for a second-stage statutory merger proposal from a bidder whose hostile takeover bid gained what ordinarily would be control. Because the first-stage takeover would be hostile, a replacement of the old board would not yet have begun, and if a staggered board were in place, full replacement might take time even when begun.¹¹⁷

Ordinarily the replacement of the old board could be achieved by calling a special meeting of the shareholders, which should be within the present ability of the successful offeror. The *Seibert* rule, however, also would permit passage of a shark repellent bylaw amendment requiring a supermajority vote to remove directors, at least without cause, when this is attempted at such a special shareholders' meeting.¹¹⁸ Even then it might seem that once the hostile bidder gained the requisite voting strength on the board, the new board could recommend approval of the

ing in large enterprises under efficiency criteria. See, e.g., Easterbrook & Fischel, *supra* note 5, at 415-16.

¹¹³ See Easterbrook & Jarrell, *Do Targets Gain From Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 279 n.6 (1984).

¹¹⁴ 380 Mass. 656, 405 N.E.2d 131 (1980).

¹¹⁵ 741 F.2d 1555 (9th Cir. 1984).

¹¹⁶ We may assume that a shareholder-adopted amendment of corporate articles or bylaws, providing for a contingent supermajority vote requirement on a statutory merger or sale of assets proposal, can itself only be changed with the approval of a percentage of shares equal to the supermajority voting requirements set in that first provision. Thus, if a vote of seventy-five percent is a possible requirement for approval of the transaction, a vote of seventy-five percent would be required to eliminate it. This common understanding only can function, however, if the establishing and changing of these sequential hurdles is left to the same decisionmaking body; i.e., to the shareholders. If the authority to change voting requirements is abdicated to the directors, the underlying and legitimate division of competences is undermined. This proposition is straightforwardly stated in *Sellers v. Joseph Bancroft & Sons Co.*, 23 Del. Ch. 13, 21, 2 A.2d 108, 112 (1938); see also Black & Smith, *Antitakeover Charter Provisions: Defending Self-help for Takeover Targets*, 36 WASH. & LEE L. REV. 699, 717 (1979) ("[S]ubstantive antitakeover charter provisions always are protected against alteration by a successful offeror by a requirement that they not be altered, amended or repealed without the consent of a greater than majority vote of stockholders.").

¹¹⁷ See Black & Smith, *supra* note 116, at 715-16; Hochman & Folger, *Deflecting Takeovers: Charter and By-Law Techniques*, 34 BUS. LAW. 537, 538 (1979).

¹¹⁸ See generally Black & Smith, *supra* note 116, at 713-17.

newly proposed merger, thus indirectly avoiding the high-vote trigger. Again, however, I see nothing in *Seibert* that would invalidate a tighter provision preventing rescission of a once-triggered supermajority vote resolution either at all or in the presence of appropriate benchmarks, prominent among which would be the simple coming-into-power of the new "hostile" board.¹¹⁹ (Indeed, the use of "incumbent" in the bylaw suggests that this additional protective device might not be needed.) The result of the delaying maneuver sanctioned by the *Seibert* rule is to seriously chill the bidding for hostile takeovers or, what is equally unsavory, to position incumbent management for goldmail.¹²⁰

The result of these contractually based defenses, all within current realms of legitimacy, is to accept the abdication—albeit voluntary—of the shareholders from their position of power over the market for voice.¹²¹ In terms of the market rationales propounded by the efficiency school, this abdication indirectly but effectively inhibits the efficiency-monitoring function of the stock market. In time the signal emitted by these defenses may drive down the value of shares of such companies and correct for such exorbitant behavior, but longrun comfort of that length is cold comfort.

At least the maneuvering allowed by *Seibert* is initiated by the voluntary decision of the existing shareholders, in the sense that their enabling amendment allows for the board's behavior. With *Jewel Companies v. Pay Less Drug Stores Northwest*,¹²² which is considered in the next subsection, we come to a shift of decisionmaking power which cannot be rationalized even on that attenuated basis. That opinion rests, rather, on a distorted view of the proper division of power between shareholders and directors as to corporate governance.

¹¹⁹ See Hochman & Folger, *supra* note 117; cf. Rosenzweig, *The Legality of "Lock-ups" and Other Responses of Directors to Hostile Takeover Bids or Stock Aggregations*, 10 SEC. REG. L.J. 291, 309-10 (1983) (arguing that a properly worded supermajority voting provision can except transactions approved by the current board from the supermajority-vote requirement).

¹²⁰ *Seibert* would enable management not earlier given golden parachutes (payments upon termination after a takeover) to extract their equivalent—goldmail—from the bidder. See generally Note, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909 (1985). The criticisms of the antitakeover maneuvers described in the text are analogous to those applicable to greenmail (repurchase of bidders' stock position for a premium). See Note, *Greenmail: Targeted Stock Repurchases and the Management-Entrenchment Hypothesis*, 98 HARV. L. REV. 1045 (1985); cf. Heckmann v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985) (preliminary injunction imposing constructive trust on proceeds of stock resale after unsuccessful takeover bid); Gilbert v. El Paso Co., 490 A.2d 1050, 1056 (Del. Ch. 1984) (allegations that bidder restructured tender offer to help target's management obtain separate benefits survive summary judgment on civil conspiracy claim).

¹²¹ See Buxbaum, *supra* note 10, at 527.

¹²² 741 F.2d 1555 (9th Cir. 1984).

4. Directors' Arrogation of the Substance of Shareholder Voting Power

The significance of *Jewel Companies v. Pay Less Drug Stores Northwest*¹²³ can only be appreciated in the context of the statutory regime governing the role of the board of directors of a target company in the event of a statutory merger or (in the California parlance) a statutory sale-of-assets reorganization.¹²⁴ Under California statutory law, as elsewhere, the board of directors functions as a gatekeeper in the initiation, negotiation, and recommendation of those transactions. The typical statute prescribes that the board shall approve the merger agreement.¹²⁵ Then, to become effective, the agreement must be submitted to the shareholders of the target entity for dispositive action.¹²⁶ While this shareholder vote may occur before or after board approval,¹²⁷ the former is not a sensible approach; it would be awkward and risky for a board to procure shareholder approval before the terms of the reorganization had been fully worked out and approved by the board. The shareholders vote only on the principal terms of the merger.¹²⁸ Before a merger becomes effective but after it has been approved by the shareholders, the board may abandon it unilaterally, subject to possible contractual rights of third parties.¹²⁹ As is argued in more detail below, this statutory scheme places a commercially sensible and necessary initiative with the board while retaining for the shareholder ultimate dispositive authority to effect the transaction. Moreover, it allows abrogation by the board in the event of originally unforeseen changed circumstances.

In *Jewel*, the Board of Directors of the target company, Pay Less Drug Stores ("Pay Less"), negotiated a friendly tax-free statutory merger with Jewel Companies ("Jewel"). Its terms included a provision obligating the Pay Less directors to use their best efforts to effectuate the merger. Thereafter a new entrant, Pay Less Drug Stores Northwest ("Northwest"),¹³⁰ announced a competing bid after initially purchasing a substantial bloc of Pay Less stock. It conditioned the bid on the Pay Less directors' abandonment of the agreement with Jewel. The Pay Less directors acceded to this change of circumstances and entered into a similar merger agreement. Both agreements, of course, were subject to shareholder approval. The Northwest agreement called for abandon-

¹²³ *Id.*

¹²⁴ See also the earlier discussion in Buxbaum, *The Law of the Jungle Meets the Law of the Ninth Circuit: Court Holds That California Law Requires Board to Honor Merger Contract*, 6 CAL. BUS. L. REP. 117 (1984).

¹²⁵ *E.g.*, CAL. CORP. CODE § 1101 (West Supp. 1985).

¹²⁶ *Id.* § 1201.

¹²⁷ *Id.* § 1201(f).

¹²⁸ *Id.* § 1201(a).

¹²⁹ *Id.* § 1105 (West 1977).

¹³⁰ Pay Less and Northwest had similar names due to a common corporate ancestor, but they were entirely unrelated companies at the time of the merger that was the subject of this litigation.

ment of the Jewel agreement whether or not the Pay Less shareholders approved the latter. In fact, they approved the Northwest merger. Jewel thereupon sued Northwest for tortious interference with Jewel's contractual relations with Pay Less.¹³¹

The court held that under California law a target board could legitimately sign the Jewel-agreement of a "standstill" provision.¹³² By doing so, the court stated, a target board reasonably could expect to gain a higher price from the first bidder.¹³³ The use of this "anti-auction" rationale¹³⁴ elevated the concept to a normative rule without full consideration of the tension between the rule and the statutory regime of shareholder participation in statutory mergers.

The following discussion of *Jewel* is divided into three parts. The first clarifies the proper role of section 1105 abandonment power by focusing on the basic question of the division of powers between board and shareholders in dealing with a statutory merger in the absence of competing bids. The second considers the special problem posed by the court's acceptance of the board's decision to bargain away its statutory authority to abandon an agreed-to merger. It also examines the court's cryptic reference to corporate liability for damages for that abandonment. The third evaluates the general problem of the coerced shareholder vote—general because it also arises in the hostile-takeover-bid situation whenever defensive maneuvers threaten to diminish the shareholders' investment in the name of saving it.

The first of these three looks at *Jewel* begins with the court's accommodation of managerial discretion with general fiduciary principles in terms of the gatekeeper scheme of the typical corporations code. This is best viewed by analyzing the extreme abuse of the same gatekeeper function found in the contract between Pay Less and Northwest. Though it was not itself analyzed by the court, it provides an essential limiting case with which to evaluate the court's treatment of the first contract between Pay Less and Jewel.

For our purposes, the critical provision of the Pay Less-Northwest agreement is the Pay Less board's pledge to use its abandonment powers against the Jewel merger.¹³⁵ Even if the majority of Pay Less shares were voted in favor of the Jewel statutory-merger proposal, the board of Pay

¹³¹ *Jewel*, 741 F.2d at 1557-59.

¹³² *Id.* at 1564.

¹³³ *Id.* at 1563.

¹³⁴ See *infra* notes 151-54 and 163-80 and accompanying text for a discussion (and criticism) of the anti-auction rule.

¹³⁵ Other terms of the agreement included: Northwest's indemnification of Pay Less and its directors for any damages they might suffer for breach of the Jewel agreement; the latest possible record date permitted by the code to determine eligibility of Pay Less shareholders to vote on the proposed Jewel merger plan, which afforded Northwest the longest possible period to obtain record ownership of the Pay Less shares tendered under its concurrent solicitation to be voted against the proposed Jewel merger; and Pay Less directors' promise to recommend acceptance of the Northwest tender offer to Pay Less shareholders. *Jewel*, 741 F.2d at 1558-59.

Less agreed thereafter to abandon that merger under the authority of section 1105. Are such agreements legitimate uses of the gatekeeper function? If not, what narrower range of director decisionmaking would be legitimate, and do the commitments of the Pay Less board to Jewel, on which the court based its acceptance of the tortious interference claim, fall within or without that narrower range of legitimate director action?

The contractual commitment of the board to exercise the section 1105 "abandonment" function on Northwest's behalf was not legitimate. The purpose of the abandonment section, which is not unique to California but is found in most state codes,¹³⁶ is to permit flexible responses to changed circumstances that arise after shareholder approval of a merger.¹³⁷ The purpose is not to reserve an ultimate decisionmaking power to directors and to relegate shareholders to an advisory-vote role. In this sense the abandonment section resembles the statutory discretion of a board of directors to rescind a dividend declaration because of changed financial circumstances.¹³⁸ Of course, third parties' contractual rights, if any, are preserved despite the abandonment. That reservation, however, has little direct bearing on the definition of the abandonment power, and what little bearing it has suggests a limited interpretation of that power.

This construction is confirmed by a closer look at the gatekeeper function per se.¹³⁹ That function is to be understood as promoting the flexibility and convenience necessary to the board's participation in the effectuation of a statutory merger, not as founding some unspecified residual authority.¹⁴⁰ The same considerations lead to making this pre-

¹³⁶ *E.g.*, MODEL BUSINESS CORP. ACT § 79(d) (1974); see also Note, *Withdrawal of Fundamental Changes Before a Vote, An Unrecognized Complement to Abandonment—A Proposed Change in Ohio's Abandonment Statute*, 32 U. CIN. L. REV. 380, 382 & n.6, 390-91 (1963) (noting prevalence of abandonment provisions and arguing for expansion of those powers to allow management to withdraw proxy statement it submitted to shareholders).

¹³⁷ 1A H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS § 257.02[3] (4th ed. 1985) (abandonment section "is designed to provide flexibility in the management of corporate affairs").

¹³⁸ See R. STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS 460 (2d ed. 1949); cf. H. BALLANTINE, *supra* note 15, at 558-60 (discussing good faith limitation on ability to rescind dividend). The leading case generally is considered to be *Ford v. Easthampton Rubber Thread Co.*, 158 Mass. 84, 89, 32 N.E. 1036, 1037 (1893) (holding board may rescind dividend where not made public nor communicated to shareholders and no funds yet set aside for distribution). Cf. *Carney v. Crocker*, 94 F.2d 914, 916-17 (1st Cir. 1938) (holding that for tax purposes a dividend was not fully and unconditionally declared if it could still be rescinded by the directors).

¹³⁹ This aspect is set forth at CAL. CORP. CODE § 1101 (West Supp. 1985) and is the statutory authority upon which the *Jewel* court rests its decision, 741 F.2d at 1561-62.

¹⁴⁰ The terms of a merger agreement usually are detailed and comprehensive. A meeting of shareholders, let alone a mail ballot from shareholders, is no way to negotiate and establish those terms. Even the ratification or approval process would be hindered, not helped, if the typical merger agreement were simply mailed to investors unexplained. It is difficult enough, even with the help of federal rules governing proxy statements, to state the principal terms of a merger agreement and to referee the presentation of arguments pro and con in the event of an intra-corporate dispute about its

liminary negotiation function the exclusive route to the shareholders. A third party whose merger proposal is rebuffed by the target's directors cannot readily put the same, unnegotiated proposal directly to the shareholders because the shareholders simply lack an effective mechanism with which to shape the transaction.¹⁴¹ All of this, however, is a matter of convenience and of adherence to effective hierarchical decisionmaking structures. It has nothing to do with a shift of ultimate decisionmaking power from shareholders to directors. No merger requiring the vote of the shareholders is effective without the vote of the shareholders.

To the degree the court's ruling on the tortious interference claim rests on the notion that the board's action itself constitutes a contract binding upon the corporation, it rests on a doubtful interpretation of the statute.¹⁴² A textual argument supports this point. Section 1105, dealing

approval. *See e.g., Denison Mines Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812 (D. Del. 1974) (preliminary injunction sought in a merger transaction on the basis that the proxies contained materially misleading omissions under § 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78n(a) (1982)).

¹⁴¹ Not even a proxy solicitation by the bidder and its allies among the target's shareholders in favor of the merger can achieve this result directly, because it is almost impossible to make an unnegotiated merger proposal an agenda item for the shareholders. Only an indirect attack is permitted: the bidder can solicit proxies for the election of a slate of target directors favorable to the proposal; then the process can start. *See generally* R. JENNINGS & R. BUXBAUM, *supra* note 9, at 287-325 (discussing the proxy solicitation process). In practice, of course, even this is too cumbersome and most persistent suitors simply would go to the takeover-bid alternative. *Cf. Easterbrook & Fischel, supra* note 109, at 1200 (arguing that a credible threat of a hostile takeover disciplines management by causing it to consider friendly merger proposals).

Quite apart from eligibility questions, 17 C.F.R. § 240.14a-8(b)(1) (1985) limits the supporting statement of the proponent of a proposal to 500 words.

¹⁴² The court fails to distinguish between operational transactions, in which the board is undoubtedly preeminent, and structural ones, in which shareholders possess the franchise. It is uncontroverted that a *necessary* step in any merger is shareholder approval, whether or not directorial approval is additionally necessary. H. BALLANTINE, *supra* note 15, at 684-85; H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS* 980 (3rd ed. 1983), *cited in Jewel*, 741 F.2d at 1560. It cannot reasonably be inferred from these statutes or commentaries, however, that directorial approval is independently *sufficient* to create a valid merger agreement. The fact that the board is subject to fiduciary duties in such dealings creates no inference to the contrary. It is difficult to imagine any official act of the board which is not subject to that duty. The court confuses necessary with sufficient conditions.

Moreover, even if one accepts the court's proposition that the power to create a binding agreement lies with the board, it does not follow that the "operational" decision is one which may be contracted away, in the sense of freezing the corporation into a particular course of action, even for a little while. *See infra* text accompanying and following notes 147-49; *see also* *Trumbo v. Bank of Berkeley*, 77 Cal. App. 2d 704, 176 P.2d 376 (1947).

Finally, the court's analysis is inconsistent with the only analogous line of California cases involving truly "managerial" decisions. Two California cases have held that a *valid* contract for the conveyance of land arises upon execution by a corporate agent, though the agreement explicitly provides that it is subject to approval by the board of the other corporate party. *Moreland Dev. Co. v. Gladstone Holmes, Inc.*, 135 Cal. App. 3d 973, 186 Cal. Rptr. 6 (1982); *Jacobs v. Freeman*, 104 Cal. App. 3d 177, 163 Cal. Rptr. 680 (1980). (*Moreland* is the progeny of *Jacobs*.) These cases rest on the dubious and much less sweeping rationale that the implied covenant of good faith and fair dealing requires that the contracts actually be submitted for board approval. *Moreland*, 135 Cal.

with abandonment of the merger, addresses only the case in which shareholder approval already has been obtained: the merger may be abandoned without "further" shareholder approval.¹⁴³ The section does not address abrogation of the contingent "agreement" made by the directors but not yet submitted to the shareholders. By necessary implication, this "agreement" does not yet exist at this point as a source of rights and duties. While the board of directors' business judgment about the appropriateness of the merger is an essential part of the merger process, this fact has no bearing on the issue of whether the board can bind the corporation by signing a merger agreement.

Even treating the problem as an original one, detached from the statutory framework, it is difficult to identify sound reasons for the court's view that the board's contract is binding. The court's assertion that its decision merely prevents the voiding of an otherwise valid contract¹⁴⁴ appears at best circular. In the end, and despite its protestations that this is not what it is doing,¹⁴⁵ the court is forced back to the anti-auction argument as the only ground for enforcing the board's preliminary contract. That argument, however, is not derivable from the statute and is subject to challenge on its own merits.

The *Jewel* decision represents a potentially pernicious inroad on the role of shareholder participation in corporate governance. The statutory regime appropriately preserves a significant measure of shareholder authority by limiting the management function to those elements required

App. 3d at 977-78, 186 Cal. Rptr. at 8-9; *Jacobs*, 104 Cal. App. 3d at 189-91, 163 Cal. Rptr. at 687-88. More to the point, however, neither court went so far as to *enforce* the contracts; rather, both courts remanded the cases for trial on the hypothetical question of whether the board would have approved the contracts had they been presented. Aside from straining the contract documents to the limit, one wonders how absence of board approval fails to prevent contract formation and yet prevents immediate enforcement. Nevertheless, the Ninth Circuit did not remand *Jewel* for trial on the issue of what the shareholders would have done had things been different, as these analogous cases also involving "managerial" decisions suggest would have been appropriate. Rather, the *Jewel* court's remand is phrased as if it expects a narrow reading of the Pay Less-Jewel contract. Cf. *Mesa Partners v. Phillips Petroleum Co.*, 488 A.2d 107 (Del. Ch. 1984) (court granted preliminary injunction based on likelihood of success on claim regarding the standstill agreement). Compare also the seeming inconsistency in the recent (and controversial) ruling that a duty to disclose a merger plan only arises when there is an agreement in principle to merge. *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 757 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985).

¹⁴³ CAL. CORP. CODE § 1105 (West 1977) provides:

The board may, in its discretion, abandon a merger, subject to the contractual rights, if any, of third parties, including other constituent corporations, without further approval by the outstanding shares . . . , at any time before the merger is effective.

A very similar provision was first adopted with the 1947 revision of the California Corporations Code. *Id.* historical note. A contemporaneous commentary by individuals familiar with the drafting of the Corporations Code confirms that the abandonment feature, with its potential third-party liability, was intended for post-shareholder vote situations. H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS § 339, at 414 (1949) ("[Abandonment] may become advisable for various reasons, including demands for cash from dissenting shareholders . . .").

¹⁴⁴ *Jewel*, 741 F.2d at 1564, 1568.

¹⁴⁵ *Id.* at 1564.

by exigent considerations: initial negotiation and evaluation of the merger, and an abandonment right based on the need for a flexible response to changed circumstances. The decision impinges upon this division of powers, since it is a logical consequence of its argument that the corporation may be exposed to liability if the shareholders, in the legitimate exercise of their statutory powers, reject the proffered agreement.¹⁴⁶

A second approach to the *Jewel* opinion suggests another aspect of the court's distortion of this division of powers.¹⁴⁷ This approach focuses on the court's implicit acceptance of the board's decision to bargain away its statutory right—and, unavoidably, duty—to abandon the merger in light of changed circumstances, for that is what acceptance of the “stand-still” commitment signifies. The court's view of the statutory abandonment power, especially its cryptic reference to possible contractual liability upon its exercise,¹⁴⁸ misconceives that power. As previously mentioned, the abandonment provisions recognize that directors, in the exercise of their fiduciary duties, may have to respond to changed circumstances (such as an unexpectedly large volume of dissenters' preliminary appraisal claims) by abandoning the merger.¹⁴⁹ Admittedly, under some circumstances third parties may be entitled to damages arising from the abandonment. The purchasing corporation may be one of these parties. Nevertheless, that does not establish the existence of the “stand-still” power attributed to the board in *Jewel*.

The use of the abandonment authority as authority for “freezing” a prospective merger deal cannot properly be characterized as a response to changed circumstances. A promise to ignore those changed circumstances is a misuse of the statutory flexibility. And the court's use of the mentioned anti-auction rationale¹⁵⁰ is hard to square with the directors'

¹⁴⁶ See 1A H. BALLANTINE & G. STERLING, *supra* note 137, at § 257.02[3].

¹⁴⁷ See Buxbaum, *supra* note 124, for a further discussion of the issues raised by these last two aspects of *Jewel*.

¹⁴⁸ *Jewel*, 741 F.2d at 1562-63 & n.10. Many jurisdictions have enacted abandonment provisions; however, they almost all require the merger agreement specifically to provide for third-party contractual rights. See, e.g., MODEL BUSINESS CORP. ACT § 79 (1974).

¹⁴⁹ See N. LATTIN, *supra* note 20, at 602; Note, *supra* note 136, at 381 (and the authorities cited therein). In fact, this statutory rule is not necessary. The typical merger agreement permits rescission once more than a threshold number of appraisal demands are filed. See Buxbaum, *supra* note 23, at 1250 & n.104.

¹⁵⁰ *Jewel*, 741 F.2d at 1563. A reasonable paraphrase of the anti-auction model is that socially desirable “synergistic” effects result from mergers and that the financial outlays necessary to the discovery of such opportunities will not be undertaken unless the discoverer is assured of reaping the benefits. The prescription, thus, is to give the first successful bidder the exclusive right to a shareholder vote, urged rather than resisted by management, in order to promote overall economic efficiency.

The most vigorous proponents of the anti-auction rule concede that it is less than firmly established. See Easterbrook & Jarrell, *supra* note 113, at 279. The debate of Easterbrook & Fischel, Gilson, and Bebchuk, *Symposium*, 35 STAN. L. REV. 1-67 (1982), is evidence of the discord. Criticisms of the ex post anti-auction rule approved in *Jewel* (i.e., applicable only once offer is approved by the board after receipt of a merger proposal) are presented in this subsection. For criticisms of an

particularized duty of prudence to the corporation's shareholders.¹⁵¹

It has been suggested that an auction after a hostile bidder has "invested" its search costs in the first bid illegitimately usurps the benefits of that expenditure. That is a highly debatable assertion, as will be seen below. Whatever its force, however, it has almost no place in the friendly statutory merger context, and not only because an incumbent management may have little arm's-length incentive to obtain an adequate quid pro quo for the surrender of the auction opportunity. A board's abandonment power not only is limited to responding to changed circumstances; it may have to be exercised under some changed circumstances under fiduciary principles. It fulfills a function which is not compatible with an anti-auction rule. Indeed, the court accepts the somewhat inconsistent position that the board may owe shareholders the fiduciary duty of advising them of a later, better offer and perhaps of withdrawing its recommendation of the first.¹⁵²

Furthermore, even assuming an absolute ex ante anti-auction rule were to yield higher initial bid prices, the contractual acceptance of an ex post anti-auction constraint by way of *Jewel* would not increase shareholders' gains. Since the initial, "investing" bidder does not know whether a merger target would accept this constraint, it would have no greater incentive to invest in a search for these targets than it would if such a constraint were unenforceable.

The court also suggested that such ex post contractual constraints are needed to induce potential bidders to make an offer. It is in a bidder's interest to move in any event, however, and a bidder would only pay more for a contract with a constraint than one without a constraint if it was already suspected that a more lucrative deal was imminent. Notwithstanding contrary assertions by the *Jewel* court,¹⁵³ it is difficult for directors to know in advance whether a contractual anti-auction constraint will benefit the shareholders. Thus prudence, as well as the statutory scheme, normally would seem to dictate the nonenforceability of these ex post exclusive merger provisions.

A third approach to this problematical case focuses on the coercive aspect of some types of agreements with bidders, a focus all the more important since the Delaware Supreme Court delivered its opinion in

absolute ex ante anti-auction rule imposed upon all mergers, see *infra* notes 163-80 and accompanying text.

¹⁵¹ The actions of a board which adopts a provision preventing further bidding in an active-bidding situation may be subject to a degree of scrutiny higher than the business judgment rule. See *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, FED. SEC. L. REP. (CCH) ¶ 92,333, at 92,216 (Del. Ch. Oct. 23, 1985), *aff'd mem.*, FED. SEC. L. REP. (CCH) ¶ 92,357 (Del. Nov. 1, 1985). For a discussion of this case, see text accompanying notes 257-60 and note 245.

¹⁵² *Jewel*, 741 F.2d at 1564; see also *infra* note 157.

¹⁵³ *Jewel*, 741 F.2d at 1563-64.

Smith v. Van Gorkom.¹⁵⁴ The critical issue under this approach is the shareholders' ability to make an uncoerced, informed decision regarding a proposed statutory merger. While *Jewel* does not involve direct coercion to ratify the board's recommended merger agreement, the decision comes close to accepting just such coercion. It thus invites a look both at this aspect of *Jewel* and at the modern variations of coercive provisions found in merger agreements.

"Lockup," "hostage," and "crown jewel" provisions have become common in merger agreements.¹⁵⁵ These provisions grant the bidder an option to purchase an important asset of the target effective only upon abrogation or other failure of the prospective merger agreement. Also emerging are liquidated-damages and substantial-penalty clauses, purporting to surcharge the target corporation if the board of directors does not honor its commitment to support the merger, or even if the shareholders fail to ratify it.¹⁵⁶ These provisions are logical extensions of the type of exclusive-merger agreement approved in *Jewel*.

The thinly veiled aim of these agreements is to prevent the shareholders from exercising their statutory right of rejection by making the costs so high that acceptance cannot fairly be characterized as a choice; rather, it is a foregone result dictated by the board's "managerial" activity of granting these options or penalties. Treating the inclusion of the option or penalty as part of the preliminary negotiating phase, assigned to the board as an element of its statutory gatekeeper function, hides the policy problem and perverts the statutory regime. There is a policy justification for inclusion of some "toll" charges in merger agreements, but these charges need to be discussed on their own merits and held to proper limits. Both the justification and the limits are based on exigent factors of operational flexibility and time constraints. They do not combine to create a blank check on the business judgment account. To grant this immunity is to change the gatekeeper function into an ultimate, dispositive power. Whether or not a factually specific case of fiduciary breach can be made out in any given case, the *Jewel* court should not have avoided the equally important and preliminary question of statutory

¹⁵⁴ 488 A.2d 858 (Del. 1985) (denying a business judgment defense to directors who acted with unnecessary haste and upon inadequate review of the terms of a proposed statutory merger).

¹⁵⁵ These have been most prevalent in "white knight" defensive tactics against hostile takeover bids. The controversial case of *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981), as well as those rejecting its approach, e.g., *Buffalo Forge Co. v. Ogden Corp.*, 717 F.2d 757 (2d Cir.), cert. denied, 464 U.S. 1018 (1983), involve federal antimanipulative rules in a hostile bidder situation. The same securities regulation issues are involved in a friendly merger situation in *Feldbaum v. Avon Products, Inc.*, 741 F.2d 234 (8th Cir. 1984), and *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), cert. denied, 466 U.S. 1052 (1984). See Note, *Lock-Up Options: Towards A State Law Standard*, 96 HARV. L. REV. 1068, 1068 n.3 (1983).

¹⁵⁶ See *Smith v. Van Gorkom*, 488 A.2d 858, 868 (Del. 1985), and the discussion of this point in Buxbaum, *Summer Lightning Out of Delaware: Smith v. Van Gorkom and the Business Judgment Rule*, 6 CAL. BUS. L. REP. 219, 221 (1985).

interpretation.¹⁵⁷

I recognize that this analysis goes a long way towards accepting the often criticized decision of *Mobil Corp. v. Marathon Oil Corp.*,¹⁵⁸ which condemns the grant of lock-up options to a solicited white knight. In the case of the hostile takeover bid, however, the coercive tactics and fast pace of the transaction may justify direct defensive actions by a board that unavoidably impinge upon the target shareholders' freedom of action. Nevertheless, even if one granted that countervailing argument in such a special situation, the use of a similar strategy simply as a preemptive or forestalling maneuver at the start of a friendly statutory merger discussion strikes me as an abuse of the directors' gatekeeping function. Such strategies transform the gatekeeping function into an arrogation of the shareholders' ultimate and statutory approval function. While the application of earlier, broader, and more preemptive defensive managerial tactics may have won the resigned acceptance of some courts under the business judgment rule, it is generally criticized by most

¹⁵⁷ This coercion example also suggests another approach to this case, one which focuses on the analogous problem of informed choice in the context of a board's fiduciary duty to its shareholders. Only in a brief dictum does the *Jewel* opinion support the need for informed choice as a condition of effective shareholder participation in these structural decisions: "[A] board may not, consistent with its fiduciary obligations to its shareholders, withhold information regarding a potentially more attractive competing offer." *Jewel*, 741 F.2d at 1564 (citations omitted). The court did not, however, consider the consequences of this rule in the context of typical merger situations. Instead, it specifically refused to indicate whether the board in this situation is obliged to recommend the initial merger proposal to shareholders despite the receipt of a more favorable offer. *Id.* at 1564 n.13.

A recommendation of the initial offer under these circumstances would seem to violate the fiduciary obligation embodied both in the gatekeeping function specifically and in the policies reflected in other sections. CAL. CORP. CODE §§ 300, 310 (West 1977 & Supp. 1985); see, e.g., *Great W. United Corp. v. Great W. Producers Coop.*, 41 Colo. App. 349, 353, 588 P.2d 380, 382-83 (1978), *aff'd*, 200 Colo. 180, 613 P.2d 873 (1980). As the court in *Belden Corp. v. InterNorth, Inc.*, 90 Ill. App. 3d 547, 413 N.E.2d 98 (1980), stated:

Belden is entitled [by its agreement with the directors of Crouse, the target company,] to have the merger presented and recommended to Crouse's shareholders. Belden . . . [does] not, however, have an unequivocal right to the benefits of the merger, since the power to approve the merger lies with the Crouse shareholders, and the contract imposes no duty on the shareholders to ratify the merger agreement.

Id. at 553, 413 N.E.2d at 102. The *Jewel* court seems to appreciate or at least to foreshadow the dilemma into which the logical extension of its views on the legitimacy of the "standstill" provisions necessarily will lead, but it gives no clue as to how the dilemma should be resolved.

Thus, use of the board's "standstill" power in friendly reorganization plans as a means to freeze its consideration of future events leaves the board in a very uncertain situation. The board must choose between frustrating the expectations of potential suitors, with the possibility of damages liability, and failing fully to inform shareholders. For a recent episode suggesting the instability that may result from *Jewel*, see Moffett & Petzinger, *Pennzoil Wins \$10.53 Billion in Suit Against Texaco: Verdict is Called Highest Civil Judgment in History*, Wall St. J., Nov. 20, 1985, at 3, col. 1 (w. ed.) (compensatory and punitive damages awarded against Texaco for inducing Getty Oil not to go through with Pennzoil merger, not yet secured by a formal contract but approved by informal vote of Getty Oil board). See also Moffett, Petzinger & Stewart, *Courting Disaster: How Texaco Turned Big Takeover Victory Into Bigger Legal Loss*, Wall St. J., Dec. 20, 1985, at 1, col. 6 (w. ed.).

¹⁵⁸ 669 F.2d 366 (6th Cir. 1981).

commentators.¹⁵⁹

There has been some concern that the recent *Unocal Corp. v. Mesa Petroleum Co.*¹⁶⁰ decision of the Delaware Supreme Court, by approving the exclusion of a hostile bidder's shares from an above-market self-tender offer, opens the floodgates to differential treatment of shareholders by their own agents. In fact the court was careful to limit its approval of Unocal's decision to exclude the recently-acquired shares held by T. Boone Pickens's Mesa Group from the general repurchase offer to the specific background facts of the case—in particular, the coercive nature of Pickens's planned two-tier tender offer and the need for a speedy and effective response.¹⁶¹ The opinion issued no general blank check. The decision indeed is troubling and potentially dangerous, but narrowly framed and narrowly interpreted it demonstrates the occasional need for an exigent inversion of principal and agent roles in the midst of a hostile takeover bid. By contrast, in the less hurried friendly statutory merger case, as in *Jewel*, these considerations have little or no place in the legal structure governing the transaction.

The above analysis demonstrates that the directors' role in the statutory merger should not be equated with their role in responding to a hostile tender offer. If such analogies are made, the result is essentially unreviewable total directorial discretion.¹⁶² Opponents of incumbent management's power to avoid hostile bids in takeover situations have persuasively argued against the use of the statutory-merger analogy, pointing out that the explicit statutory assignment of a role to directors creates a distinction. Since on the whole the state judiciary has not been hospitable to this basic argument and continues to apply the business judgment rule to defensive maneuvers against hostile bids, the problem now comes from the other side. It is now important to prevent this spill-over, and a clear understanding of the purpose and limits of the gatekeeper function is essential to that task. If we continue to honor that statutory framework and recall the limited policy justifications for rising above it—the structural need for the agent's on-the-spot flexibility in negotiation, and the occasional need for speedy responses to a flanking sortie by a potentially coercive hostile bidder—we will not fall prey to this easy yet fallacious argument of equivalence.

¹⁵⁹ For a recent critique, with full citations to similar previous arguments in the literature, see Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1156-61, 1261-62 (1984).

¹⁶⁰ 493 A.2d 946 (Del. 1985).

¹⁶¹ *Id.* at 958. The court's second rationale, that the Mesa group did not plan to control Unocal, *id.*, is less appealing. Why should the investor's vision for realization of profits matter in this context?

¹⁶² *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir.) (board decisions to make defensive acquisitions or file antitrust suit protected by business judgment rule), *cert. denied*, 454 U.S. 1092 (1981); *Treadway Cos. v. Care Corp.*, 638 F.2d 357 (2d Cir. 1980) (decision to sell shares to a white knight protected).

5. The Shortcomings of Efficiency Rationales for Erosion of Shareholder Participation in the Reorganization Transaction

Forestalling arrangements such as lockups and closed-shop agreements are defended primarily by extending to the statutory merger arena the mentioned "anti-auction" rationale, which originally was developed to constrain target management defensive maneuvers in hostile tender-offer-situations.¹⁶³ That rationale suggests that in time, and overall, higher offers for control will emanate from first bidders if acquisition targets agree not to solicit or even to entertain bids from later competing bidders. These second bidders may be freeriding on the first bidder's presumed significant and already sunk investment in the search for and evaluation of potential acquisition targets. It is argued that this may produce both a shortrun and a longrun type of inefficiency. In the short run, the freeriding bidder may win, though its use of the target's resources might be less efficient than would be their use by the stymied first bidder. In the long run, any reduction in future search investments is inefficient because the number of takeover bids may decrease, and with it their role in monitoring the stock markets for suboptimally performing targets.¹⁶⁴

¹⁶³ See Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) [hereinafter cited as Easterbrook & Fischel, *Auctions*]; Easterbrook & Fischel, *supra* note 109.

¹⁶⁴ This argument for the anti-auction rule and its premise of significant search costs assumes too much. First, not all—and perhaps few—mergers find their impetus in the desire to realize some benefit only disclosed by costly research. The fact of a merger indicates nothing about whether such search expenses have been incurred. Rather, as is true of transactions of all sorts, the parties simply may have differing preexisting evaluations of the best use of the resource (i.e., its real value to them); such judgments neither necessarily require cost in creation nor guarantee that anyone involved will generate the optimal "synergistic" effect. Thus, the anti-auction rule is inappropriate in cases which generated no search costs to be protected. Moreover, one suspects it is rather easy for a first bidder to conjure up such "costs" even if the anti-auction theory is fine-tuned to turn on their actual existence. To the extent the anti-auction rule is correct about search costs, it is overstated as a general legal rule because it posits such costs in all instances.

Further, inasmuch as overall economic efficiency is the touchstone for the anti-auction theorists, their arguments are undercut to the extent later bidders are able to merge with the target and produce an even greater synergistic effect. A rule giving entitlement unflinchingly to the first bidder, without effective opportunity for a competitor to intervene, will haphazardly generate potentially huge opportunity costs as measured by the differences between (best) later bidder "synergistic" benefits and first bidder benefits. This is an unnecessary loss to the extent the later and better qualified bidder (in terms of social benefit) would eventually have made the discovery anyway. There is no reason to believe that any interim loss during that longer discovery period necessarily outweighs the benefits later produced by the better qualified bidder. *But cf.* Easterbrook & Fischel, *Auctions, supra* note 163, at 13-15 (arguing that best (later) bidder can buy target's assets from first bidder and suspecting that transaction costs from resale might be less than those associated with lengthy auction). For an actual case seemingly at odds with the suspicion of Easterbrook and Fischel, see Morris & Johnson, *Case of Indigestion: How Beatrice Adjusts to Latest Takeover, This Time Itself*, Wall St. J., Dec. 5, 1985, at 1, col. 6 (w. ed.) (discussion of series of takeover transactions involving Beatrice resulting in investment banker fees of more than \$130 million and golden parachutes and severance packages of more than \$116 million).

In any case, the economic efficiency benefits of the anti-auction rule are at best equivocal. At least as viable a view is that searches involve a bargained-for risk, whose costs, as in the case of dress designs and Hula-Hoops, may be recovered with profit, or may not.

The anti-auction rationale, which is adapted from general analyses of the problems posed by inadequate legal protection of information,¹⁶⁵ has been challenged persuasively on empirical as well as on analytical grounds,¹⁶⁶ and its proponents have scaled it back significantly in response.¹⁶⁷ Four less profound but perhaps more practical objections can be added to that challenge.

One objection derives from traditional antitrust policy. Information differs only in degree from a variety of otherwise analogous investments like research and development, advertising that generates goodwill, market development costs, and similar expenditures or "properties." Nevertheless, challenges to freeriding rivals—who pirate dress designs, infringe patents or trademarks, or breach certain forms of territorial exclusivity clauses—are not always successful. Those claims are balanced by consideration of the competitive structure of the relevant markets in which the contending actors offer their products and services.¹⁶⁸ Thus, entitlements derived from private law are to varying degrees tested against public law criteria before courts enforce them against trespassers.

The failure to consider the relevant market undermines the efficiency rationale in the statutory merger situation. By contrast, the efficiency rationale, which is premised on the existence of functioning stock markets, would allow the firms themselves to determine that the benefits from their investment searches outweigh any inefficiency caused by imperfect market structures. That approach may or may not be defensible in the case of hostile takeover bids, depending on how sensitively the (proposed) legal rule varies with the competitive structure of the market in which these prohibitions on auctions would operate. A fortiori, then, private anti-auction arrangements in friendly statutory-merger or tender-offer situations would have to be similarly controlled. It is the market for firms, not the stock market, which is the relevant market in this case. And a market in which the bidder can cause the target to accept such a constraint cannot be characterized as competitive. Such oligopsonistic

¹⁶⁵ See, e.g., Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971); Kitch, *The Nature and Function of the Patent System*, 20 J.L. & ECON. 265, 283-84 (1977).

¹⁶⁶ See Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 870-75 (1981).

¹⁶⁷ See Easterbrook & Fischel, *Auctions*, *supra* note 163, at 17-21.

¹⁶⁸ See, e.g., 1 J. MCCARTHY, TRADEMARKS AND UNFAIR COMPETITION § 1:15, at 37-38 (2d ed. 1984).

[I]t is permissible in a competitive economy for the second comer to try to capture as much of the first comer's market as it can. . . . For example, one can capitalize on a market fad created by another so long as the public is not confused into mistakenly believing that the product emanates from or is sponsored by the original creator.

Id. (footnote omitted); see also Easterbrook, *The Supreme Court, 1983 Term—Foreword: The Court and the Economic System*, 98 HARV. L. REV. 4, 21-29 (1984) (analyzing protection of intellectual property on the basis of economic efficiency considerations that include appropriate market structure conditions).

behavior suggests what other evidence confirms:¹⁶⁹ on the whole, target companies are smaller and more numerous than bidding companies. Since target companies are likely to be price takers, and bidders likely to be price setters, the efficiency rationale, premised on an adequately if not perfectly competitive market structure, cannot justify an anti-auction rule.

The second objection to the anti-auction rule concerns its underlying "efficient stock market" rationale.¹⁷⁰ A functioning information market, it would seem, should signal the existence of a suboptimal enterprise situation simply by intrasector comparative data, if nothing else.¹⁷¹ The market should identify bidding situations with a good deal less investment search than is postulated by the advocates of the anti-auction rule. If it does not, then it may be either that the market is not "efficient" or that many takeovers have nothing to do with a search for suboptimal performers. While facts are always suspect in this kind of analysis, observers suspect that the latter conclusion explains a distressingly large number of cases.¹⁷²

These additional challenges to the anti-auction rationale, coupled with those proffered by Bebchuk¹⁷³ and Gilson,¹⁷⁴ gain additional force when one considers that in the friendly merger or takeover situation the first ("investing") bidder negotiates the actual takeover share price with the very management whose hypothetically suboptimal performance is the bedrock for the entire efficiency-sanctioned search process.¹⁷⁵ As even the proponents of the rationale agree,¹⁷⁶ the incumbent management may have little incentive to bargain hard for its shareholders. The

¹⁶⁹ Cf., e.g., Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 281-94 (1983) (reviewing studies finding that the market often undervalues stocks). The author concludes:

The focus on short-term expectations, as reflected in the dramatic stock turnover rates and the rapidly changing lists of favorite industries and individual stocks, systematically produces a group of out-of-favor companies. With almost 10,000 publicly traded securities to choose from, we should expect to find in almost any season takeover candidates in substantial numbers. It is like fishing in a well-stocked pond. A competent bidder should catch his supper; if the next fish is caught by someone else, the bidder with patience will still be rewarded.

Id. at 306.

¹⁷⁰ See generally Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). For a recent discussion of a related shortcoming of the efficient-markets hypothesis, concentrating on the inability of contractual bargaining and stock pricing mechanisms to control management, see Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1423-26 (1985).

¹⁷¹ Cf. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 57-62 (1982).

¹⁷² See Lowenstein, *supra* note 169, at 305-06; cf. Coffee, *supra* note 159, at 1207.

¹⁷³ Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982).

¹⁷⁴ Gilson, *supra* note 171.

¹⁷⁵ Gilson, *supra* note 166, at 850; see also Coffee, *supra* note 159, *passim*.

¹⁷⁶ Easterbrook & Fischel, *Auctions*, *supra* note 163, at 12.

management is already “targeted”—for even the friendly bid has done that—and thus is likely to be on the way out. After its dispersal to golden retirement or diffuse other positions, the taint of its earlier collective, suboptimal performance will dissipate. That conflict-laden situation can only be aggravated if the target management can offer the bidder an exclusive first bid. The offer may well encourage the collusive split of an already chilled premium between the targeted management and the bidder.¹⁷⁷ Whatever the efficiency justification for using anti-auction rules to protect hostile takeover bids, that justification is weaker to the point of inherent contradiction in this special case of friendly, anti-auction protected bids.

One other practical consideration militates against the anti-auction rationale or rule. A putatively friendly bidder may transmit an initial expression of interest with or without a price proposal. That dissipates the advantage of its prior search, and exposes its sunk costs to appropriation. The target management at that moment is in a position to stimulate an auction merely by revealing its receipt of an expression of intent.¹⁷⁸ Yet no contract constraining the target management from making such an announcement exists, nor is it likely that even the most extreme proponent of an anti-auction rule in hostile offer cases would deem it sensible to extend it to that case. To do so would give any putative bidder, before it has made any commitment to act, a costless option on the target company.¹⁷⁹

This *reductio ad absurdum* seems to confirm the conclusions reached through the preceding arguments. The statutory merger and the negotiated tender offer present situations that do not justify and thus do not permit the enforcement of severe¹⁸⁰ contractual restraints on the consideration of competing offers. To allow these contracts is to allow what can only be characterized as a usurpation of the shareholders’ supremacy in the approval of mergers and similar structural transactions.

¹⁷⁷ Gilson, *supra* note 166, at 846; see Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 731 (1985) (expressing analogous doubts about management negotiation in leveraged buyouts).

¹⁷⁸ This was dramatically shown by the events surrounding General Food’s recent announcement that it had “received an unsolicited takeover offer from a potential buyer willing to pay a premium over . . . market value.” *General Foods Gets Takeover Proposal; Suitor May Be Cash-Rich Philip Morris*, Wall St. J., Sept. 25, 1985, at 3, col. 2 (w. ed.). Although General Foods did not reveal the name of the potential buyer, the price of General Foods’ common stock increased almost 20% by closing time on announcement day. *Id.*

¹⁷⁹ See Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1043 n.67 (1982).

¹⁸⁰ Modest, appropriately defined liquidated damages clauses committing the company to pay legitimate expenses of the first provisionally accepted bidder should be acceptable. *Cf.* Buxbaum, *supra* note 124, at 119 (“Such expenses would not include the general expenses of searching for a merger candidate, but would comprise only expenses of negotiation with the selected target, standby financing commitments, legal fees and similar items.”).

C. *The Elimination of the Voting Right of Common Stock*

Nonvoting common stock is another device that requires an assessment of the role of shareholder participation. Nonvoting common stock is not a new phenomenon. As early as 1917 a New Jersey Chancery decision upheld Bethlehem Steel's issuance of a nonvoting common stock as a stock dividend.¹⁸¹ Bethlehem Steel Corporation's motivation was tangentially related to control: the new shares might have been sold by current owners in order to realize indirectly a cash return on their earlier investment, but the old ownership and control patterns would not have been disturbed by this extra float. The court emphasized the broad statutory enabling language¹⁸² and indicated that already at that time about fifteen corporations, including some very large ones, had similar common stock classifications. Some current state statutes permit, at least by direct implication, the issuance of two classes of common stock.¹⁸³

The current revival of nonvoting common stock—and the reinvention of its correlate, supervoting shares—is the result of the search for “showstopping” defenses to hostile takeover bids.¹⁸⁴ As recently put by an authoritative source:

To increase their ability to thwart such a hostile offer, many companies have proposed to their shareholders recapitalizations whereby two classes of common stock are created, one class having significantly greater voting power per share than the other. The terms of the stock

¹⁸¹ *General Inv. Co. v. Bethlehem Steel Corp.*, 87 N.J. Eq. 234, 100 A. 347 (Ch. 1917). The issuance of nonvoting common stock was specifically authorized by a shareholder vote to increase the capital authorization. See also the contemporaneous discussion in A. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 74-77 (rev. ed. 1926), suggesting that these early issues might be better seen as “weakened” preferred stock species.

¹⁸² The court quoted a statute providing for the “power to create two or more kinds of stock, of such classes, with such designations, preferences and voting powers or restrictions or qualifications thereof as shall be stated” in the articles of incorporation. *General Inv. Co.*, 87 N.J. Eq. at 240, 100 A. at 350 (quoting N.J. CORP. ACT § 18 (1896)).

¹⁸³ While the current version of the California statute, CAL. CORP. CODE § 400(a) (West 1977) (“A corporation may issue one or more classes or series of shares or both, with full, limited or no voting rights . . .”), is not materially different from the prior version, Act of July 1, 1947, ch. 1038, § 1100, 1947 Cal. Stat. 2309, 2326-27 (formerly codified at CAL. CORP. CODE § 1100 (West 1955)), *repealed by* Act of Sept. 12, 1975, ch. 682, § 6, [1975] 1 Cal. Stat. 1514, 1516. § 1201(a) of the current code contains a strong hint that the concept is legitimate. In relevant part it states: “For the purpose of this subdivision [shareholder ratification of reorganization], two classes of common shares differing only as to voting rights shall be considered as a single class of shares.” CAL. CORP. CODE § 1201(a) (West Supp. 1985). This implicit reference to two different voting classes of common stock was missing from § 1201(a)'s predecessor, Act of July 1, 1947, ch. 1038, § 4107, 1947 Cal. Stat. 2309, 2377 (formerly codified at CAL. CORP. CODE § 4107 (West 1955)), *repealed by* Act of Sept. 12, 1975, ch. 682 § 6 [1975] 1 Cal. Stat. 1514, 1516.

¹⁸⁴ It has been reported that perhaps five percent of the 2200 or so corporations represented on the computer-based NASDAQ “exchange” have issued some version of subvoting or supervoting common stock to public or management holders, respectively. Klott, *A Fight Over Unequal Stock*, N.Y. Times, Oct. 22, 1985, at 29, col. 3 (nat'l ed.). For a list of companies on the NYSE that recently have adopted some form of two-class common stock, see Ragsdale, *Firms Face NYSE Show-down Over Voter Violations*, San Francisco Examiner, Nov. 3, 1985, at D-3, cols. 3-4.

typically include provisions that will eventually result in the concentration of the higher voting stock in the hands of management, thereby making virtually impossible any acquisition [sic] of the company other than in a transaction satisfactory to management.¹⁸⁵

In one recent transaction, the controlling shareholders of Fedders Corporation, who owned approximately twenty percent of its outstanding stock and comprised its management, obtained some of the benefits of a going-private arrangement, while simultaneously embedding the supervoting stock as a takeover defense. The controlling owners proposed, and the outside shareholders authorized by charter amendment, the issuance of a new class of supervoting shares with a markedly lower dividend rate. The new supervoting shares were made available to any shareholder through a right to convert the original single class of common stock. The controlling owners fully disclosed, however, that it would have made little economic sense for any outside shareholder to have exercised this conversion right. Unless all outside shareholders had exercised this option, such shareholders, as a class, would have had even less "control" of the corporation than before. In addition, the outside shareholder would have lost some dividend flow, as against nonconverting holders, in the bargain.¹⁸⁶

This was not a financing proposal; the corporation would have gained no new money from the new class. Rather, it was purely a control-augmenting transaction, creating something like an internalized version of the old public-utility holding-company pyramid.¹⁸⁷ Over the long run, of course, it does not matter whether the issuance of nonvoting stock originally was a financing device or not.¹⁸⁸ The same two consequences emerge. First, the control remains with the original shareholders and, to the degree that the originally existing control bloc tends to buy up more

¹⁸⁵ SUBCOMMITTEE ON SHAREHOLDER PARTICIPATION AND QUALITATIVE LISTING STANDARDS, N.Y. STOCK EXCH., DUAL CLASS CAPITALIZATION 3 (1985) (Initial Report). For the genesis of the New York Stock Exchange's prohibition of two-class common stock, see J. Kerbel, *Main Street and Bay Street: Restricted Shares Come to Ontario* 79-80 (1985) (unpublished LL.M. thesis, Harvard Law School) (on deposit at Harvard Law School Library).

¹⁸⁶ See, e.g., Fedders Corp., *Exchange Offer by Fedders Corporation of Class B Stock for Shares of Common Stock* 5-18 (June 7, 1985) (offering circular).

¹⁸⁷ For an early discussion of this form of structure, which multiplied fractional control holdings of operating subsidiaries through several tiers of parent or holding companies and thus allowed a relatively small investment in the top holding company to control a much larger lower-tier investment, see A. DEWING, *supra* note 181, at 753-83. The microeconomic dangers of this kind of structure, which led to legislative reform, are equally apparent in this new, internalized version. See M. EISENBERG, *supra* note 1, at 311-12.

¹⁸⁸ See the brief discussion of this practice, suggesting its purpose is to secure control, in F. IACOBUCCI, M. PILKINGTON & J. PRICHARD, *CANADIAN BUSINESS CORPORATIONS* 111-12 (1977). A glance at *THE FINANCIAL POST SURVEY OF INDUSTRIALS* (58th ed. 1984) (annual survey), makes clear that these nonvoting, so-called "restricted shares" indeed are a common Canadian phenomenon. Conversations with informed sources suggest that many Canadian issuers, prevented from or unwilling to consider tapping the U.S. capital market for fear of even greater Americanization than already exists, found nonvoting equity stock a useful tool in this situation.

than its current number of voting shares, the controlling group will obtain more power. The Fedders version significantly hurried up the process, but that process would tend to occur even if the present outside shareholders temporarily held on to their old-style stock. Secondly, valuation of the two classes of stock becomes complicated. One would expect some differential between the two classes of stock to develop, but it would be a differential that mixes elements of dividend return and of control-premium benefit.

Whether used as a shield or, to date more rarely, as a sword, these mechanisms tend to grant incumbent management something close to a veto power over any possible merger or takeover bid. If the supervoting shares also come to have that same magnified power with respect to the election of directors, and that is occasionally the case,¹⁸⁹ few agency-related sanctions (as distinguished from stock-market and credit-market related sanctions) would remain to control excessive agency costs. As a result, potentially hostile tender offers would tend to give way to friendly tender offers, negotiated with the entrenched management, and proxy conflicts would become nonexistent. This negotiation process is susceptible, as already mentioned,¹⁹⁰ to the collusive sharing of the potential gains accruing from the difference between the target company's understandably depressed share values and their potential values under different management.

The lack of voting power also may put nonvoting common shareholders at additional risk of management misbehavior or inefficiency, thus further depressing the price of the nonvoting shares. As one study puts it:

The vulnerability of a share of nonvoting stock to the adverse exercise of managerial discretion (moral hazard) would make these securities far less marketable than common shares today

One reason that the voting right for common shares has seemed unimportant to some observers is that they have assumed that the managers are heavily dependent on the equity market for capital. . . . But many corporations make little use of the equity market for capital. The moral hazard or "agency" problem inherent in the nonspecific obligations managers have toward stockholders then becomes particularly important and makes the voting right a crucial safeguard of stockholders' interests.¹⁹¹

¹⁸⁹ See Fedders Corp., *supra* note 186, at 10.

¹⁹⁰ See *supra* text accompanying notes 175-77.

¹⁹¹ FitzRoy & Mueller, *Cooperation and Conflict in Contractual Organizations*, 24 Q. REV. ECON. & BUS. 24, 39-40 (1984). The authors further explained the control problem shareholders face:

A stockholder with a fractional holding . . . still . . . [has], in principle, some control over the manager, but, more important, . . . [he also has] partial guarantee of . . . mobility. We emphasize this point, since some recent discussions of the stockholder-manager relationship assume that the shareholder's voting right is an incidental and irrelevant aspect of the stockholder-management contract. This is false, if we think of the rest of the provisions

The few surveys of the pricing of nonvoting common shares—mainly Canadian and Israeli studies as well as one report on the much smaller cohort of American two-class common-stock issues—suggest the existence of a substantial price differential between the types of stock.¹⁹²

From an enabling perspective, corporations may not be able to create two-class common stock unless they provide statutory protections available in other contexts for analogously affected classes. Where, as in the Fedders situation,¹⁹³ the new supervoting class is designed to be unattractive to any shareholder not part of the management control bloc, courts should treat the noncontrolling shareholders as a preexisting sepa-

of the contract remaining unchanged. Given the unspecified nature of the obligations placed on the managers[,] . . . there is nothing to stop the managers from reducing the dividends paid to zero, and allowing the stock's price to fall accordingly. The voting rights attached to shares prevent this by allowing some stockholders to seize control and exercise a monitoring function

Id. at 39. This view is generally shared by Williamson, *Perspectives on the Modern Corporation*, 24 Q. REV. ECON. & BUS. 64, 68 (1984).

¹⁹² One unpublished study of thirty American issuers of two-class common stock (mostly Amex listings) suggests the existence of a control premium (measured by the difference in price between a company's supervoting and subvoting stock as a percentage of the price of the subvoting stock) of an average of over five percent in twenty-six companies. See Levy, *Economic Evaluation of Voting Power of Common Stock*, 38 J. FIN. 79, 80, 88 (1983) (citing R. Lease, J. McConnell & W. Mikkelsen, *The Market Value of Control* (May 1981) (working paper)). Levy's own study of Israeli two-class common stock confirms this finding. *Id.* at 88 ("In Israel . . . the voting rights premium ran well above 100% for many firms, which implies that the controlling group in Israeli firms derives a significant direct (or indirect) benefit, which does not exist in the United States.") See, however, the suggestion that further work is needed on this issue in L. DeAngelo & H. DeAngelo, *The Allocation of Voting Rights in Firms with Dual Classes of Common Stock*, Working Paper No. MERC83-17 (Nov. 1983) (University of Rochester, unpublished).

This control premium may reflect enfranchised shareholders' ability to use their voting power to counter appropriation of profits by management. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Control Behavior*, 3 J. FIN. ECON. 305, 312-30, 351-52 (1976). For an argument that under some circumstances an efficient market may penalize a corporation for profit appropriation by management, see Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 707 (1982).

¹⁹³ See *supra* text accompanying note 186. Although the Fedders' board made "no recommendation whether any stockholder should exchange his or her shares for shares of Class B Stock," Fedders Corp., *supra* note 186, at 1 (emphasis omitted), the analysis in the offering circular assumed that "the Giordano family [the largest single group of shareholders] will probably own most of the Class B Stock," *id.* at 10. The lack of a public market for the Class B stock, restrictions on alienation, and its lower dividend rate make it unattractive to a shareholder not large enough to be the majority holder of Class B Stock and thus benefit from its supervoting rights for the election of directors triggered by a hostile takeover attempt or the nomination of a dissident slate of directors.

Where subsequent conversion into nonvoting shares is not freely allowed, the two-class-stock problem is an application of the same prisoners' dilemma that characterizes shareholder choice in takeover bids. See Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1720-23 (1985) (discussing dilemma in stock tender offer where shareholders fear first-stage offer will be higher than second-stage offer to remaining shareholders). Shareholders who would prefer to retain shares in the voting class need to consider the danger that fellow shareholders will convert. Indeed, the two-class-stock problem is more coercive, because the decision of any shareholder to convert to nonvoting shares reduces the proportionate voting power of outside shareholders vis-a-vis the control bloc.

rate class of stockowners that should have a class vote apart from the control bloc on transactions such as mergers. The courts should analogize to the already-mentioned treatment of charter amendments that must be voted on by each separate class (including each series of preferred stock) if the series are differentially affected by the proposed single "class" amendment.¹⁹⁴ It might also be noted parenthetically that at least in California such enabling questions may be moot because both classes of common stock, once issued, would have equal voting rights in the event of a merger or analogous reorganization.¹⁹⁵ These stringent interpretive views of the enabling procedures are fully justified given the significant fiduciary duty problems for the controlling bloc created by the introduction of two-class stock. The risk associated with even the mild versions of two-class common stock used in Canada,¹⁹⁶ for example, stems from the opportunity to develop separate markets for the potent stock—i.e., in the problem of a class-based sale of control.¹⁹⁷

At the same time, this introduction of two-class stock creates an efficiency issue. If public shareholders need not be solicited by bidders for control, they will be unable to escape the market-value loss caused by management's suboptimal performance following their investment. For that very reason Canadian regulators and legislators have been concerned with mechanisms to protect holders of nonvoting stock.¹⁹⁸ One such "coattail" device is mandatory rights to convert the nonvoting stock at the time of a takeover bid. It seems likely that similar requirements

¹⁹⁴ See *supra* text accompanying note 69. This obviously resembles the voluntary "guest voting" tactic in conflict-of-interests reorganizations, which conditions completion of the merger on the approval thereof by an appropriate majority of the outside shareholders. See *infra* text accompanying notes 240-43; see also CAL. CORP. CODE § 310(a)(1) (West 1977).

¹⁹⁵ This result would follow from the mandate of sections 1201(a), 152, and 117, when they are read together, as they have to be. CAL. CORP. CODE §§ 117, 152, 1201(a) (West 1977 & Supp. 1985); see *supra* note 87 and accompanying text (discussing interpretation of § 1201(a)).

¹⁹⁶ See *supra* note 188.

¹⁹⁷ This is already a significant problem given a dubious tendency to appraise minority-held shares at a discount because they are not within a "control bloc." Compare *Moore v. New Ammest, Inc.*, 6 Kan. App. 2d 461, 475, 630 P.2d 167, 177 (1981) (twenty-percent discount in value of minority shares deemed proper), and *Hernando Bank v. Huff*, 609 F. Supp. 1124, 1126 (N.D. Miss. 1985) (allowing discount in value of minority shares to determine fair value of dissenters' shares), with *Brown v. Allied Corrugated Box Co.*, 91 Cal. App. 3d 477, 485-87, 154 Cal. Rptr. 170, 175-76 (1979) (minority shares not discounted for lack of control, because purchaser is already in control). For dicta suggesting an economic justification of premiums for control blocs, see *Beerly v. Department of the Treasury*, 768 F.2d 942, 946-47 (7th Cir. 1985).

¹⁹⁸ As an example of this reconsideration of the Ontario Securities Commission's long-standing Policy No. 3-58, see Policy Statement on Restricted Shares, 4 CAN. SEC. L. REP. (CCH) ¶ 815-421 (Apr. 14, 1982), which would have required significant substantive conditions such as "coattail" obligations on offerors to bid for nonvoting shares in takeover efforts. This proposal was the subject of heated debate, and was ultimately rebuffed in favor of the continuation of the earlier, less restrictive policy. Policy No. 1.3, Restricted Shares, 3 CAN. SEC. L. REP. (CCH) ¶ 54-897 (amended Dec. 21, 1984).

For a full discussion of Canadian practice in the context of this legal debate, see J. Kerbel, *supra* note 185.

will be imposed in the United States, probably through regulations under the Williams Act regulatory changes, when and if the American developments turn these experiments into steady-state financing mechanisms. In any event, the fiduciary problems at the least should lead courts to apply such protective measures as the above-discussed separate vote of the non-control shareholders at the time of adoption of the enabling charter amendments.¹⁹⁹

An even more problematical type of differentiation is the time-phased voting right, which would "temporarily" disenfranchise normal common stock upon its sale.²⁰⁰ It is an absolute "showstopper" in that it poisons the holdings of a hostile bidder upon transfer of the stock to it, typically for thirty-six or forty-eight months, which is too long for the bidder to wait out. Unlike all other defensive strategies devised to date, it would seem to be immovable. The successful bidder-owner still has no vote vis-à-vis those who have retained their holdings, presumably management, unless evasive devices like proxies were to be accepted. Time-phased disenfranchisement provisions also confound the market evaluation processes, which are already strained by the two-class stock structures. They are much more contingent a danger and probably would lead to extremely deep discounts because of the simple uncertainty of when and how sharply that danger would come home to roost.

This last and worst type of defensive restraint, which can be emplaced only with shareholder approval under most modern statutes governing analogous transfer restrictions, is probably unworkable because of

¹⁹⁹ For the present, paradoxically, the regulatory effort is centered on state law. Because of the reported impasse within the NASDAQ Board of Governors and, perhaps, an expectation of continuing delay in resolving the listing problem at the NYSE, the California Commissioner of Corporations has been reported to be considering a regulatory exemption from that Department's permit requirements for a second class of common stock, if it meets certain conditions: a 10:1 limit on the vote disparity and a guarantee for the subpar stock of at least twenty-five-percent board representation.

²⁰⁰ The recently enacted amendment of the Certificate of Incorporation of Potlatch Corporation (a Delaware company) illustrates the concept:

V. VOTING RIGHTS

(a) A holder of the common stock shall, except as otherwise provided in paragraph[h]

(b) . . . hereof, be entitled to one (1) vote on each matter submitted to a vote at a meeting of stockholders for each share of the common stock held of record by such holder as of the record date for such meeting.

(b) A holder of the common stock shall be entitled to four (4) votes on each matter submitted to a vote at a meeting of stockholders for each share of the common stock held of record by such holder as of the record date for such meeting which meets one or both of the following criteria:

(1) such share of the common stock has had the same beneficial owner or owners since December 12, 1985; or

(2) such share of the common stock has had the same beneficial owner or owners for at least 48 consecutive calendar months . . . prior to the record date for such meeting

. . . .

Potlatch Corp., Notice of Special Meeting of Stockholders app. A (Oct. 22, 1985) (proxy statement); see *Potlatch Corp. Gives Long-Term Holders More Voting Power*, Wall St. J., Dec. 13, 1985, at 54, col. 4 (w. ed.).

the need to obtain the consent of each affected shareholder. Already one federal lower court decision, ostensibly applying Delaware law, has suggested that section 202 of the Delaware statute would apply.²⁰¹ That section does not forbid transfer restrictions but, as does California law,²⁰² makes them unenforceable against shareholders who did not vote for them.²⁰³ This rule would seem to apply equally to dissenting shareholders' transferees, since to do anything else would vitiate indirectly the benefit of the assent requirement. While theoretically the temporary disenfranchisement, assuming the correctness of the transfer restriction analogy, could be upheld against those shareholder-sellers who had voted in favor of the restriction, that result would be hard to implement in the case of publicly traded shares.

The common danger presented by all of these defensive responses is the merging of sale-of-control problems with excessive agency-cost problems. At best these combined dangers can be avoided only through the stock market exit solution. If that exit possibility is even further compromised by the mentioned impact upon market values, a genuine legitimization crisis could result. Extremely longrun market corrections probably would develop, and as a result nonvoting stock would be valued below other stock and financing of corporate expansions by new equity issues would be made more difficult. Nevertheless, the additional ameliorative safeguard arguably available through the market for control would be dissipated. Here, then, efficiency considerations and constitutionalist considerations alike would seem to counsel the regulation of these developments.

D. The Appraisal Remedy as a Means to Exclude Equitable Relief

The element of voice—the ability to exercise or deliver control—is not the only attribute at issue in this discussion of the division of powers in corporate governance. Adequate conditions of exit—the price available for cashed-out or exchanged shares in reorganizations—not only lurk in the background of the preceding discussion of control, but are directly at issue when a dispute erupts over the financial terms of a merger. Dissenters from a collective decision often are granted a second round by way of an appraisal remedy.²⁰⁴ At the same time, availability of that remedy can be used as a reason to downplay the danger that loyalty problems may taint both the voting and the price-setting processes.

²⁰¹ *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407, 409-10 (S.D.N.Y. 1985) (applying DEL. CODE ANN. tit. 8, §§ 141(c), 157, 202(b) (1985)).

²⁰² CAL. CORP. CODE § 204(b) (West Supp. 1985).

²⁰³ These time-phased restrictions may not apply at all to a reorganization under California law. See *supra* note 195.

²⁰⁴ Buxbaum, *supra* note 23, at 1230-33.

1. Introduction and Background

One explanation of the development of the appraisal remedy is that fundamental changes such as mergers originally could not be effected without the unanimous consent of all holders of voting stock. The appraisal remedy for dissenters from such transactions was the price paid for acceptance of majoritarian decisions.²⁰⁵ In a sense, we have arrived a century later at a new version of that bargain. Today, the merger of a controlled but only partially owned subsidiary into its dominant parent is on its way to being immunized from conflict-of-interests challenges (and the equitable relief available thereunder) in return for a generous appraisal remedy.

The phenomenon of "conflict-of-interests reorganization" is prevalent. It has particularly great potential to cause disputes because of its role in the second stage of a takeover transaction.²⁰⁶ Both original and second-stage conflict-of-interests mergers share the attribute that, absent legal constraints, the parent shareholder is in a position to impose the terms of the merger exchange and to force their acceptance. In the latter case, however, the adversarial posture of the dominating parent company already was signalled by the earlier takeover bid. Nontendering target-company shareholders are thus to some extent on notice that they cannot expect a solicitous attitude from the new majority shareholder. Consequently, courts well may be hesitant to impose on such dominant new shareholders the fiduciary duties presumably deemed appropriate in the case of an original conflict-of-interests merger proposed and pushed through by a controlling parent company shareholder in a longstanding, steady-state situation.

The statutory treatment of conflict-of-interests reorganizations is relatively new. Only California has explicitly connected enabling provisions with the appraisal remedy.²⁰⁷ Mergers effectuated by means of the surviving company's control position are treated differently from mergers between entities at arm's length. Dissenters from control-position mergers have the right to equitable and legal relief, and also benefit from the

²⁰⁵ See *Voeller v. Neilston Warehouse Co.*, 311 U.S. 531, 535 n.6 (1941) (dicta) (Black, J.); *Chicago Corp. v. Munds*, 20 Del. Ch. 142, 149, 172 A. 452, 455 (1934) (dicta); *Woodward v. Quigley*, 257 Iowa 1077, 1086-87, 133 N.W.2d 38, 42-43 (1965); Manning, *supra* note 25, at 226-28; see also M. EISENBERG, *supra* note 1, at 75 (1976).

²⁰⁶ See Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1359-65 (1978) (discussing the absence of a fiduciary relationship in a two-stage merger and the need for regulation to prevent deception and abuse of position); Greene, *Corporate Freeze-out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487, 491-96 (1976) (discussing freezeout of minority in second stage of merger and potential fairness problems due to lack of arm's-length bargaining).

²⁰⁷ See Small, *supra* note 86, at 1217-23. This goes back to Professor Ballantine's uncharacteristically harsh view of suits against mergers if only a pricing dispute was involved. See Ballantine & Sterling, *Upsetting Mergers and Consolidations: Alternative Remedies of Dissenting Shareholders in California*, 27 CALIF. L. REV. 644, 648-50 (1939); cf. Buxbaum, *supra* note 204, at 1244 (1976). See generally Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189 (1964).

imposition upon the merger's proponents of the burden of proving that the transaction is fair and reasonable.²⁰⁸ Dissenters from arm's-length mergers are relegated to the appraisal process for their exclusive remedy.²⁰⁹ Indeed, recent jurisprudence emphasizes the exclusivity of the appraisal remedy for third-party mergers and reads the statute as proscribing even damages actions, although the statute literally proscribes only suits to enjoin such mergers.²¹⁰ For conflict-of-interests mergers, on the other hand, the appraisal remedy is no bar to actions at law or equity either to enjoin or to rescind the transaction, nor for monetary relief on a basis presumably more generous than that obtainable through an appraisal process.²¹¹

The common law jurisprudence prevailing in other jurisdictions, however, now is well on the way to assimilating questions of fairness of terms and legitimacy of purpose within the appraisal process, albeit by means of an appraisal remedy tailored to the very point at issue—self-dealing and fairness. This, of course, is the lesson to be derived from the much commented-on opinion of the Delaware Supreme Court in *Weinberger v. UOP, Inc.*,²¹² which brought an end to that court's brief experiment with a nonappraisal approach to fairness. After decades of indifference to the motivation or fairness of conflict-of-interests reorganizations, that court in 1976 embarked on its short-lived but significant course of testing the fairness of such arrangements by way of the so-called "business purpose" test.²¹³ Unfortunately, this approach was not instrumental or refined enough to overcome the earlier patterns of Chancery jurisprudence,²¹⁴ largely because it originated in a specific variant of conflict-of-interests arrangements, the freeze-out or cash-out merger.

²⁰⁸ CAL. CORP. CODE § 1312(b)-(c) (West 1977).

²⁰⁹ *Id.* at § 1312(a).

²¹⁰ *See* *Sturgeon Petroleum, Ltd. v. Merchants Petroleum Co.*, 147 Cal. App. 3d 134, 139-41, 195 Cal. Rptr. 29, 32-34 (1983).

²¹¹ *Cf.* R. JENNINGS & R. BUXBAUM, *supra* note 9, at 1129-30.

²¹² 457 A.2d 701 (Del. 1983). *See, e.g.*, Burgman & Cox, *Reappraising the Role of the Shareholder in the Modern Public Corporation: Weinberger's Procedural Approach to Fairness in Freezeouts*, 1984 WIS. L. REV. 593; Weiss, *Balancing Interests in Cash-Out Mergers: The Promise of Weinberger v. UOP, Inc.*, 8 DEL. J. CORP. L. 1 (1983).

²¹³ The business purpose test was stated by the court in *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), as: "We hold the law to be that a Delaware Court will not be indifferent to the purpose of a merger when a freeze-out of minority stockholders on a cash-out basis is alleged to be its sole purpose." *Id.* at 979; *see also* *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032 (Del. 1979); *Tanzer v. International Gen. Indus.*, 379 A.2d 1121 (Del. 1977). This line of cases was overruled by *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983).

²¹⁴ *See, e.g.*, *David J. Greene & Co. v. Schenley Indus.*, 281 A.2d 30, 35 (Del. Ch. 1971). For a review of the pre-1976 jurisprudence, *see* E. FOLK, *THE DELAWARE GENERAL CORPORATION LAW* 336-39 (1972). In addition, I believe it is arguable that the literalistic yet exasperated tone of some of the post-1976 Chancery opinions sent a strong signal to the Supreme Court concerning the views of the trial bench on the difficulty of operationalizing that "business purpose" trilogy of Supreme Court cases. *See, e.g.*, *Najjar v. Roland Int'l Corp.*, 387 A.2d 709 (Del. Ch. 1978), *aff'd*, 407 A.2d 1032 (Del. 1979), *overruled*, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983).

More specifically, this special solicitude towards the minority shareholders against whom the controlling owner attempted to exercise a private right of eminent domain always suffered from an overinclusive and overdetermined framework. For example, the business purpose test was applied even to cash-out mergers explicitly permitted by statute, known as “short form” mergers,²¹⁵ and thus appeared to run against the grain of a legislative enabling philosophy. The doctrine might have been applied only to “long form” cash-out mergers—situations in which the controlling-parent-company shareholder owned less than the high percentage triggering short-form possibilities.²¹⁶ Had it been so limited, it might have been seen as merely a judicial fiduciary requirement for what was itself a judicially created enabling mechanism. Then, however, it was compromised by the failure to distinguish cash-out transactions initiated by publicly-held companies, which of course are not true cash-out situations because the shareholder always can reinvest in the acquiring firm, from those initiated by privately-held companies.

As a result, the Delaware Chancery understandably viewed most of these disputes as being over the financial terms of the exchange and not really over the dominant party’s right to force the transaction. It developed a relatively unsympathetic attitude towards dissenters’ efforts both to second-guess the terms of the offer and to sidestep the available appraisal process,²¹⁷ even though at that time the appraisal process was concededly unsatisfactory.²¹⁸

2. The Assimilation of Fiduciary Rules Within the Appraisal Process

Weinberger made clear that Delaware case law has accepted the legislative concept of an exclusive appraisal remedy, not only for arm’s-length mergers but also for “legitimate” cash-out mergers.²¹⁹ “Fairness

²¹⁵ *Najjar v. Roland Int’l Corp.*, 387 A.2d 709 (Del. Ch. 1978), *aff’d*, 407 A.2d 1032 (Del. 1979), *overruled*, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983).

²¹⁶ See CAL. CORP. CODE § 1101 (West Supp. 1985) (prohibiting long-form cash-out mergers entirely in the conflict-of-interests reorganization).

²¹⁷ The lower court opinion in *Weinberger* is a good example of this. *Weinberger v. UOP, Inc.*, 426 A.2d 1333, 1342-43, 1348-50 (Del. Ch. 1981), *rev’d on other grounds*, 457 A.2d 701 (Del. 1983).

²¹⁸ See the famous footnote 4 of Judge Mansfield’s concurrence in *Green v. Santa Fe Indus.*, 533 F.2d 1283, 1297 n.4 (2d Cir. 1976), *rev’d*, 430 U.S. 462 (1977). The remedy has been significantly improved. See DEL. CODE ANN. tit. 8, § 262(b) (1983).

²¹⁹ The *Weinberger* court stated:

[W]e return to the well established principles . . . mandating a stockholder’s recourse to the basic remedy of an appraisal.

....

In view of the fairness test which has long been applicable to parent-subsidiary mergers, . . . the expanded appraisal remedy now available to shareholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate, we do not believe that any additional meaningful protection is afforded minority shareholders by the business purpose requirement . . .

457 A.2d at 715 (citations omitted).

of dealing", of course, is required.²²⁰ "Fairness," however, is basically a matter of full and fair disclosure (and perhaps of creating a simulated negotiation process); it is not a matter of constraint on the substantive terms of the merger.

Weinberger involved a freeze-out type of conflict-of-interests reorganization, but it was not an "illegitimate" freeze-out of shareholders by a control-bloc owner through the gimmickry of a temporary holding company. Signal's ownership of UOP, while of recent vintage, predated the merger decision. The merger decision itself, while not based entirely on traditionally legitimate aims of structural simplification, was at the least a legitimate second stage of a takeover transaction. Thus it is still an open question whether the court's approach to the problem of fairness in *Weinberger* precludes future attacks on the ground of the categorical unfairness of less legitimate types of cash-out mergers.²²¹

The *Weinberger* court also used the occasion to revise the much-maligned "weighted average method" of appraisal, which mixes asset value, market price, and capitalized earnings in proportions determined by the desired outcome.²²² The revision is a desirable modernization. In the present context, the court's turn to "any techniques or methods which are generally considered acceptable in the financial community,"²²³ especially to the discounted-cash-flow approach, is particularly interesting. The discounted-cash-flow approach, a major example of these new methods, provides the rhetorical framework for admission of post merger, synergistic values into the test for fair price in conflict-of-interests mergers.

For legitimation of these revisions, the *Weinberger* court turned back to a generation-old precedent, *Tri-Continental Corp. v. Battye*,²²⁴ emphasizing in a quotation therefrom an alleged continuity of practice.²²⁵ It also significantly expanded the mysterious 1981 amendment to the appraisal statute,²²⁶ reading the vague mandate to consider "all rele-

²²⁰ *Id.* (citing *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (Del. 1952)).

²²¹ The treatment of cashouts by privately held companies also remains an open question. See, e.g., *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 123-24, 371 N.Y.S.2d 550, 553-54 (upholding state attempt to prevent third-party merger, because minority would be frozen out), *aff'd*, 50 A.D.2d 787, 377 N.Y.S.2d 84 (1975); cf. *Efron v. Kalmanovitz*, 249 Cal. App. 2d 187, 191-92, 57 Cal. Rptr. 248, 251 (1967) (rescinding sale of assets to company owned by majority shareholder because of unfairness to minority shareholders and lack of good faith of majority shareholder).

For the present, I also do not speculate whether *Weinberger* and its reasoning apply to conflict-of-interests mergers in which the noncontrolling shareholders of the target entity receive voting stock in the surviving parent corporation.

²²² *Weinberger*, 457 A.2d at 703-04. For an exhaustive review and critique of the "Delaware block" or weighted average method, see Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 840-64 (1984).

²²³ *Weinberger*, 457 A.2d at 713.

²²⁴ 31 Del. Ch. 523, 74 A.2d 71 (Del. 1950).

²²⁵ *Weinberger*, 457 A.2d at 713.

²²⁶ DEL. CODE ANN. tit. 8, § 262 (1983).

vant factors" in determining "fair" value as a justification for consideration of provable post-merger values.²²⁷ The court adopted this view even though the same section of the appraisal statute retained the earlier-enacted exclusion of "any element of value arising from the accomplishment or expectation of the merger."²²⁸ The court construed this language merely to bar consideration of speculative effects of the merger.²²⁹ In reality, however, this exclusion was inserted into the statute in 1971 to forestall the consideration of synergistic value, as propounded in the well-known though practically problematical Brudney-Chirelstein argument.²³⁰ Thus, excessively speculative elements of post-merger value are impermissible because they are not susceptible of proof, not because of any conceptual inhibition.

It is interesting to contrast the statutory development in Delaware with that of New York.²³¹ In 1982 the New York appraisal statute was amended to delete the prior exclusion of "any appreciation or depreciation directly or indirectly induced by [the merger]," and specifically to require a court to "consider the nature of the transaction giving rise to the shareholder's right to receive payment for shares and its effects on the corporation and its shareholders" as well as "all other relevant factors."²³² Apparently the New York legislature did not trust the New York courts to demonstrate the sovereign attributes of their Delaware counterparts without explicit encouragement.

A second element the *Weinberger* court allowed to be weighed in this special appraisal process concerns "any damages, resulting from the taking, which the [minority] stockholders sustain as a class."²³³ This factor authorizes the trial court to take into account as it deems proper value diminution in minority shareholders' stock from the majority parent company's depressing the value of noncontrol shares because of its domination of the subsidiary.²³⁴

In my opinion this cryptic but radical shift in the appraisal method should and will be used to distinguish between the range of business judgment permitted independent directors and the narrower range permitted self-dealing directors in conflict-of-interests transactions. Under

²²⁷ *Weinberger*, 457 A.2d at 713 (discussing DEL. CODE ANN. tit. 8, § 262(h)).

²²⁸ DEL. CODE ANN. tit. 8, § 262(h) ("[T]he Court shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger . . .").

²²⁹ *Weinberger*, 457 A.2d at 714.

²³⁰ Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) (since arm's-length-bargained mergers are impossible in the parent-subsidary context, courts should review them using a fairness standard and require the parent to split synergistic gain with the subsidiary).

²³¹ See Seligman, *supra* note 222, at 842.

²³² N.Y. BUS. CORP. LAW § 623(h)(4) (McKinney Supp. 1983-84).

²³³ *Weinberger*, 457 A.2d 701, 713.

²³⁴ It is obviously still unsettled whether this value diminution is limited to illegitimate transactions or will apply to a control shift as such.

section 144 of the Delaware General Corporation Law,²³⁵ self-dealing transactions are valid only if "fair." The consistent judicial gloss on the adjective "fair" requires "intrinsic," "entire," and "inherent" fairness, a notion clearly intended to state a higher duty than that imposed on arm's-length transactions.²³⁶ This duty, plus the attendant burden of proof also imposed by the doctrine, makes a substantive difference. The words of Judge Learned Hand provide an illustration in another old but equally relevant opinion, *Ewen v. Peoria & Eastern Railway*.²³⁷

In the case at bar, however, it must be at once admitted that . . . it is wholly impossible even approximately to set the terms upon which the "Central" and the "Peoria" would have agreed at arm's-length. On the other hand it may in fact be possible to set limits on either side outside of which one can say with some assurance that the parties would not have agreed at all: that is to say, that the "Peoria" would have been unwilling to accept less . . . and that the "Central" on the other hand would have been unwilling to give more Under such a test the crucial question becomes who carries the burden of proof. If the "Peoria" carries it, it will not succeed as to a given division, unless it was outside the range we have described; if the "Central" carries it, it will not succeed unless it would have refused to deal at all on terms more favorable to the "Peoria" than those it made.²³⁸

A determination of the instrumental test for determining value diminution recognized by *Weinberger* still lies in the future. Even so, we are on the way to accepting the legitimacy of conflict-of-interest reorganizations in the enabling sense. The price of their acceptance will be the close scrutiny of the terms of reorganization, analogous to the scrutiny of operational conflict-of-interest transactions.²³⁹

The third and final modification introduced by *Weinberger* concerns

²³⁵ See its review in E. FOLK, *supra* note 214, at 74-88.

²³⁶ While Folk equates the standard for conflict-of-interest mergers with a hypothetical standard for independent directors, *id.* at 86-87 (based on *Johnston v. Greene*, 35 Del. Ch. 479, 121 A.2d 919 (Del. 1956)), recent cases add adjectives like "intrinsic" and "entire" to the noun "fairness." As the court in *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971), puts it in a general, not only statutory, context: "The standard of intrinsic fairness involves both a high degree of fairness and a shift in the burden of proof." *Id.* at 719-20.

²³⁷ 78 F. Supp. 312 (S.D.N.Y. 1948), *cert. denied*, 336 U.S. 919 (1949).

²³⁸ *Id.* at 317.

²³⁹ Doubts about the room for a judicial fairness review left by *Weinberger*, expressed in *Lowenstein*, *supra* note 177, at 774, were at least in part answered by the opinion in *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1104-05 (Del. 1985). While the case rests on somewhat special facts (the controlling parent company-shareholders' avoidance of a most-favored-nations clause committing it to pay the subsidiary's remaining minority shareholders a minimum price), its strong language regarding the procedural aspects of fair dealing suggests that the appraisal remedy will not be the exclusive remedy even for cases alleging less than deceptive conduct.

On the other hand, this close scrutiny is triggered not by the existence of the structural conflict of interests above, but by the initial demonstration that a real arm's-length bargaining process had not been used. For the same court's treatment of a conflict-of-interests reorganization whose process and terms did satisfy the *Weinberger* analysis, see *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985).

the instrumentally vague judicial acceptance of the “advisory” vote by informed and disinterested (minority) shareholders on the terms of the proposed merger. Following *Michelson v. Duncan*,²⁴⁰ the court again borrowed the solution of section 144²⁴¹ by shifting the burden of proof of unfairness to the challengers in the event of a favorable advisory vote. It applied the solution, however, only to the disclosure and “fair dealing” aspects of the transaction, not to the pricing aspects.²⁴² That, of course, is a result predicated upon the facts of this particular case. It is possible, though unlikely, that the Delaware Supreme Court might let this advisory vote affect the just-formulated principles governing the appraisal process even as to the pricing aspect. This development, if it occurred, would be undesirable, because the appraisal process should be “outside” the high-pressured atmosphere of the merger process to allow for a comprehensive and deliberate accounting of value.²⁴³

E. Recent Inroads on Board Authority in Defensive Maneuvers

The stock-restructuring arrangements discussed in section C, whatever their merits, are shareholder-approved arrangements. If approved by informed and disinterested shareholders, they presumably represent a tradeoff between the loss of agency-monitoring power in the future (both directly and through the market for control) and the present benefits derived from the effective functioning of autonomous agents who rent capital.

Some arrangements, however, are not adopted by shareholder agreement, but are imposed by the board of directors on the basis of power originally delegated in the articles of incorporation.²⁴⁴ These include the general delegation of managerial power, used to justify the already discussed lock-up options, scorched-earth asset sales, payment of greenmail, and the like. Other options, such as the issuance of a series of preferred stock “parked” with management allies, or poison pill preferred stock or rights schemes, are based on the purportedly more specific delegation power contained within the concept of “blank stock.”²⁴⁵ Indeed a recent

²⁴⁰ 407 A.2d 211 (Del. 1979).

²⁴¹ DEL. CODE ANN. tit. 8, § 144 (1983).

²⁴² *Weinberger*, 457 A.2d 701, 703, 712; cf. Weiss, *supra* note 212, at 44-45 (assessing *Weinberger's* approach to valuation and fair dealing).

²⁴³ For a critical review of the ability of any appraisal process to capture in the pricing review alone all fairness issues left unresolved by investment bankers' opinion and outside shareholders' ratification, see Thompson, *Squeeze-Out Mergers and the “New” Appraisal Remedy*, 27 CORP. PRAC. COMMENTATOR 193 (1985).

²⁴⁴ See Buxbaum, *supra* note 10, at 537.

²⁴⁵ This device is described in Chittur, *Wall Street's Teddy Bear: The “Poison Pill” as a Takeover Defense*, 11 J. CORP. L. 25, 33-40 (1985); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The “Poison Pill” Preferred*, 97 HARV. L. REV. 1964 (1984). The Delaware Supreme Court upheld the legality of a poison pill in *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985), *aff'd*, 490 A.2d 1059 (Del. Ch. 1985), stating that the board acted within its discretion under the business judgment rule, when it adopted the pill in the absence of a takeover bid as a

revision of the Delaware General Corporation Law takes the enabling and delegation concept to a new extreme by specifying more exactly this blank-filling power and by authorizing a committee of the board of directors to exercise that issuance and specification power.²⁴⁶

A few recent federal decisions have attempted to check this effort to combine managerial discretion with full "showstopping" elements. In these cases the "showstopping" went beyond the use of the poison pill merely as a signal that management needs breathing space to improve its bargaining posture for better takeover terms. For instance, in *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*²⁴⁷ the court relied on the absence of enabling grounds to enjoin the issuance of a poison pill preferred

measure to strengthen the board's bargaining position in future contests. See *infra* text accompanying notes 261-63.

It is not yet clear to what extent defensive measures, including but not limited to the poison pill, are shielded by the business judgment rule. The four major recent cases do not yield a congruent result; of course, each is distinguishable from the others on the facts. In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), involving a target company's stock repurchase offer which discriminated against the shares held by the hostile bidder, whose behavior the court found to be coercive, the Delaware Supreme Court said, "If the board of directors is disinterested, has acted in good faith and with due care, its decision [to install defensive measures] in the absence of an abuse of discretion will be upheld as a proper exercise of business judgment." *Id.* at 957. In *Moran*, the same court extended the benefit of the business judgment rule to a directorial decision to issue a complex poison pill in advance of an impending takeover bid. On the other hand, in *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, FED. SEC. L. REP. (CCH) ¶ 92,333, at 92,220-21, 92,222-23 (Del. Ch. Oct. 23, 1985), *aff'd mem.*, FED. SEC. L. REP. (CCH) ¶ 92,357 (Del. Nov. 1, 1985), which involved lock-up options to a white knight, the Delaware Chancery Court stated, "Where . . . the lock-up option is extended to foreclose further bidding in an active bidding situation and to promote an agreement which relieves the directors of the potentially damaging consequences of their own defensive policies, . . . [t]he business judgment rule does not protect such action." *Id.* at 92,222-23. And in *Hanson Trust PLC v. ML SCM Acquisition Inc.*, FED. SEC. L. REP. (CCH) ¶ 92,418 (2d Cir. Jan. 6, 1986), *rev'g* *Hanson Trust PLC v. SCM Corp.*, FED. SEC. L. REP. (CCH) ¶ 92,376 (S.D.N.Y. Nov. 26, 1985), a case somewhat similar factually to *Revlon*, the court, nominally applying New York law, and disclaiming any indication of target director self-interest, invalidated a lock-up option, intimating that the fiduciary duty of care requires affirmative and conscientious consideration of the effects of powerful defensive steps on shareholder welfare, a consideration difficult to achieve in the heat of an active takeover battle: in other words, an amalgam of *Revlon's* substantive position and the procedural position of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). *ML SCM Acquisition Inc.*, FED. SEC. L. REP. (CCH) ¶ 92,418, at 92,557-59.

Adoption of defensive measures, such as a poison pill, may cause the board to "assum[e] a great degree of responsibility by providing a substitute for the marketplace which ordinarily would judge the merits of . . . [a] potential acquiror's . . . tender offer." *Revlon*, FED. SEC. L. REP. (CCH) ¶ 92,333, at 92,220; see Greenhouse, *Merger Game Altered by New Rulings*, N.Y. Times, Dec. 30, 1985, at D1, col. 3 (city ed.).

Whatever the outcomes of these legal battles, the poison pill is no longer viewed as the invincible defensive measure that it once was. Hertzberg, *Poison Pill Defense No Longer Is Seen As a Sure Way to Repel Hostile Suitors*, Wall St. J., Oct. 31, 1985, at 14, col. 1.

²⁴⁶ DEL. CODE ANN. tit. 8, § 141(c) (Interim Supp. 1985) (Act of July 4, 1985, ch. 127, § 3, 65 Del. Laws), now authorizes a committee of the board to designate the preferences of previously authorized blank preferred stock, which is often the vehicle for effectuating these defensive measures while preserving the fiction of shareholder approval.

²⁴⁷ 618 F. Supp. 407 (S.D.N.Y. 1985); see *supra* text accompanying note 201.

series that included a time-phased disenfranchisement provision triggered by a transfer of the stock. The court reasoned:

[*Providence & Worcester* and *Unocal*] are not applicable where the discrimination strips the shareholder of the ability to transfer voting rights without prior warning, compensation or shareholder authorization, creating two classes within one series of shares—those that have been recently acquired, with reduced votes, and those that have not, with full votes—and it does this in the face of a provision of the corporation's certificate of incorporation explicitly providing [for the identity of all shares within one series, actually a statutory requirement,] Under Delaware law, a change in corporate structure of this magnitude . . . requires stockholder approval which has not been obtained.²⁴⁸

This decision, nominally based on Delaware law, may have been undercut by the recent and already controversial²⁴⁹ decision of the Delaware Supreme Court in *Moran v. Household International, Inc.*,²⁵⁰ discussed below, upholding against a similar enabling-grounds challenge a potent poison pill transaction characterized by the lower court as “novel and complicated . . . [and in] its very complexity . . . designed to create uncertainty on the part of a potential acquirer.”²⁵¹

Two other recent federal decisions applying New Jersey law have gone further and have questioned the availability of the blank stock delegation power for “ordinary” poison pill preferred stock.²⁵² They argue that the “percentage of ownership” discrimination inherent in the functioning of the poison pill feature cannot be based on that delegated authority. This rationale, by necessary implication, leads to the refusal to adopt the problematical *Providence & Worcester* distinction between “class-based” attributes or at least to the refusal to extend it to ordinary poison pill issuance of preferred stock.²⁵³

²⁴⁸ *Unilever Acquisition Corp.*, 681 F. Supp. at 410.

²⁴⁹ *Et Tu, Delaware?*, Wall St. J., Nov. 21, 1985, at 30, col. 1 (w. ed.) (editorial criticizing *Moran* as jeopardizing efficiency gains stemming from takeovers).

²⁵⁰ 500 A.2d 1346 (Del. 1985), *aff'g* 490 A.2d 1059 (Del. Ch. 1985).

²⁵¹ 490 A.2d 1059, 1065-66 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985).

²⁵² See *Asarco, Inc. v. Holmes a Court*, 611 F. Supp. 468 (D.N.J. 1985); *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985).

²⁵³ See *supra* text accompanying notes 100-03. The Delaware Chancery decisions have not gone so far as my argument would suggest—they have considered the problem primarily in the context of fiduciary duty. Indeed, *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985), *aff'g*, 490 A.2d 1059 (Del. Ch. 1985), affirmed the board's discretion to issue poison-pill preferred with a percentage-of-ownership trigger, but it then subjects the actual exercise of that issuance authority to fiduciary analysis under the relatively deferential application of the business judgment rule in *Unocal*, 493 A.2d 946, 954. Its perfunctory bow towards *Van Gorkom*, 488 A.2d 858, is vitiated by its failure to consider the much more relevant—and more stringent—statement of directorial duty in *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, FED. SEC. L. REP. (CCH) ¶ 92,333, at 92,220-21 (Del. Ch. Oct. 23, 1985), *aff'd mem.*, FED. SEC. L. REP. (CCH) ¶ 92,357 (Del. Nov. 1, 1985). See *supra* note 245.

The second of these two federal opinions²⁵⁴ is particularly interesting because it rests on recent federal appellate decisions²⁵⁵ expressing second thoughts about the whole issue of evaluating incumbent management's defensive strategies from the business judgment perspective. Thus, as one experienced commentator recently suggested:

[D]efendant directors may be losing their first line of defense in these situations. The business judgment rule may be out because a conflict of interest will be presumed. The defendants will then have the *immediate* burden of showing that their conduct was in the best interests of the shareholders and the corporation.²⁵⁶

The Delaware court has been trying to find similar common ground for its treatment of incumbent management's defensive strategies, but it has only succeeded in providing a very mixed set of signals. One signal suggests the tightening of judicial scrutiny of directorial motivation for the use of these defenses in the heat of an actual takeover battle. The complicated fact situation of *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*²⁵⁷ involves the efforts of the target firm's board to repel a hostile bidder. First, the target board employed the now-customary combination of a self-tender offer and a poison pill warrant that, once triggered by the usual events, would have entitled the holder to exchange one share of Revlon common stock for a one year interest-bearing note. Thereafter, when these maneuvers not only had failed to repel the bidder but had become something of a financial embarrassment to Revlon, the board granted a friendly bidder lockup options on major firm assets along with a commitment not to shop further for other bids.

In granting a preliminary injunction against the effect of these com-

²⁵⁴ *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985) (available on Westlaw).

²⁵⁵ See, e.g., *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984), cited and discussed in *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1261 (S.D.N.Y. 1985) (finding *Norlin* "very instructive"). But cf. *Radol v. Thomas*, 772 F.2d 244, 257 (6th Cir. 1985).

²⁵⁶ Sommer, *The Norlin Case and Business Judgment Rule*, 17 REV. SEC. REG. 799, 803 (1984) (emphasis in original); see *Hanson Trust PLC v. ML SCM Acquisition Inc.*, FED. SEC. L. REP. (CCH) ¶ 92,418 (2d Cir. Jan. 6, 1986), rev'g *Hanson Trust PLC v. SCM Corp.*, FED. SEC. L. REP. (CCH) ¶ 92,376 (S.D.N.Y. Nov. 26, 1985). But see *Treco, Inc. v. Land of Lincoln Sav. & Loan*, 749 F.2d 374, 378-79 & n.8 (7th Cir. 1984) (antitakeover measures, which made removal of directors more difficult, reviewed under business judgment rule despite their effect of perpetuating incumbent directors' control, unless that effect was their "sole or primary purpose").

The *Treco* approach lends force to Gilson's objection that an intractable conflict of interests is ignored once an investment reason for the challenged transaction is asserted. Gilson, *supra* note 166, at 830-31. *Norlin* and *ML SCM Acquisition Inc.*, on the other hand, suggest that traditional doctrinal analysis can meet this challenge. But see McCord, *Limiting Defensive Tactics in Tender Offers: A Model Act for the Protection of Shareholder Decisionmaking*, 21 HARV. J. ON LEGIS. 489, 498-99, 506-08 (1984) (noting "the difficulty in proving subjective intent where management's motives appear mixed," *id.* at 498-99 (footnote omitted), and advocating "[a] set of specific prohibitions . . . tailored to facilitate judicial decisionmaking in the context of a preliminary injunction," *id.* at 508).

²⁵⁷ FED. SEC. L. REP. (CCH) ¶ 92,333 (Del. Ch. Oct. 23, 1985), *aff'd mem.*, FED. SEC. L. REP. (CCH) ¶ 92,357 (Del. Nov. 1, 1985).

mitments, Justice Walsh (sitting as Chancellor) provided guidelines that may be of general significance to a larger set of transactions than those at issue in the case.

[Upon the adoption of the poison pill defense, the] Revlon Board thus assumed a great degree of responsibility by providing a substitute for the marketplace which ordinarily would judge the merits of Pantry Pride's, and any other potential acquiror's, tender offer. . . .

. . . .
. . . The board's self-interest in resolving the Noteholders' problems led to concessions which effectively excluded Pantry Pride to the detriment of Revlon's shareholders. Thus the element of loyalty may turn, as it does here, [on] the selection of a takeover defense or a bargaining device that is not proportionate to the objective needs of the shareholders but merely serves the convenience of the directors. . . .

A lock-up agreement is not *per se* illegal and its use as a bargaining tool to encourage the participation of a prospective bidder has been approved. . . . A lock-up provision, however, must advance or stimulate the bidding process, not retard it, and toward that end the interests of the shareholders are best served through encouraged competition.²⁵⁸

The opinion indirectly approves various rebuffing actions, but does so in narrow rather than broad terms, as demonstrated by its reliance on *Unocal Corp v. Mesa Petroleum Co.*'s²⁵⁹ requirement of a reasonable belief in the bidder's coercive impact upon stampeded shareholders.²⁶⁰ The stringent conditions for legitimation which the court put on auction-restraining behavior are equally significant.

This impression, however, is badly undermined by the same court's analysis in *Moran v. Household International, Inc.*,²⁶¹ which followed less than one month later. Paradoxically, the court uses the fact that the company, Household International, was *not* facing or already embroiled in a hostile takeover bid as a major reason for bestowing the benefits of the business judgment rule and its deferential standard of review on the transaction.²⁶² The court could have used this occasion as the perfect one for requiring recourse to the shareholders for approval of entrenching this poison pill defense structure. Instead, the court aggravated the uncertainty surrounding this defensive maneuver by staking everything on judicial review of the board's eventual decision—presumably upon the emergence of a hostile bid—to issue the stock and rights.²⁶³

²⁵⁸ *Id.*, at 92,220-21, 92,222-23 (citations omitted).

²⁵⁹ 493 A.2d 946 (Del. 1985).

²⁶⁰ *Moran*, 500 A.2d 1346, at 1350, 1356-57 & n.14. This definition of the legitimacy of selective defensive measures, and not its questionable preference for firm-maintaining over firm-dispersing investment purposes, is *Unocal's* instrumental contribution to this subject. See *supra* note 161.

²⁶¹ 500 A.2d 1346 (Del. 1985).

²⁶² *Id.* at 1350.

²⁶³ *Id.* at 1357; cf. also *Brown v. Ferro Corp.*, 763 F.2d 798, 802-03 (6th Cir. 1985) (suit

As for the fundamental perversion of shareholder and director roles forced by this director-enacted bylaw amendment authorizing the issuance, the court trivialized the problem. The court first responded with a highly speculative argument that the poison pill might not work anyway, then rested on the following inappropriate analogies—inappropriate because the analogous steps are heat-of-the-battle steps.

The [poison pill] Rights Plan will result in no more of a structural change than any other defensive mechanism adopted by a board of directors. The Rights Plan does not destroy the assets of the corporation. The implementation of the Plan neither results in any outflow of money from the corporation nor impairs its financial flexibility. . . .

. . . [I]t does less harm to the value structure of the corporation than do the other mechanisms. Other mechanisms result in increased debt of the corporation.²⁶⁴

Whether this decision will stem the slight turn in the tide against the poison pill gambit, or whether its very uncertainty will hasten the turn, obviously cannot yet be predicted. At the least, however, the fiduciary overtones of this review of enabling provisions that may be interpreted to allow two-class common stock, if not time-phased disenfranchisement stratagems, suggest that state common law, as well as statutory law, may be starting to control these runaway battles.

Because the hostile bidder's side is exclusively within the preemptive grasp of the federal judiciary,²⁶⁵ this recent development does little to assure an overall balance of legal control of both sides to these corporate restructuring transactions. But at least in the case of friendly reorganizations, the increasing sophistication and responsiveness of state law doctrines would be significant. And even in the hostile takeover field, the developments should sensitize federal courts to the legitimacy of substantive and macroeconomic concerns about the interests of both sides in these merger wars. State law involvement in the control of tender offers is outside the scope of this Article, but I would hope that a clearer understanding of the subjects reviewed here might benefit the ongoing discussion of those issues as well.

III

CONCLUSION

State corporation law is in a state of flux, partly caused by, and partly a cause of, a crisis of nerve. In the central sector of shareholder

challenging golden parachutes dismissed as not ripe, because no actual payments would occur until there was a merger, no merger was foreseeable, and no deterrent effect to future takeovers had been shown), *cert. denied*, 106 S. Ct. 344 (1985).

²⁶⁴ *Moran*, 500 A.2d at 1354. The court listed as the "other mechanisms" sale of prize assets, payment of greenmail, and discriminatory self-tender.

²⁶⁵ See *Edgar v. MITE Corp.*, 457 U.S. 624 (1982); *cf.*, e.g., *Cardiff Acquisitions, Inc. v. Hatch*, 751 F.2d 906 (8th Cir. 1984).

governance rights, traditional enabling-law philosophy, excessively aggressive efficiency rationales, and powerfully focused managerialist strategy have combined to weaken an already inarticulate faith in the primacy of owner over manager.²⁶⁶ The efficient capital market and the market for control, however, not only are inadequate substitutes for a firm sense of the right relationship(s) between owner and manager in real-time, real-world institutional settings,²⁶⁷ but are themselves savaged by many of the new arrangements discussed above. At least some of these arrangements mock efficiency in the name of efficiency, and bury shareholder participation in the name of praising it.

This Article began as a status report on current developments affecting shareholder participation in corporate governance. As it turned to more detailed and more critical explanation and evaluation of specific transactions, it inevitably has come to emphasize the fundamental importance of the intracorporate division of powers to the proper regulation of this entire panoply of fundamental changes. Current theorems of economic efficiency favor an unbridled bidding market for control, but persistent, real-world contradictions, such as the management-initiated leveraged buyout, confound many of the assumptions underlying those theorems. On the target side of the transaction, both efficiency and constitutionalist theorems keep up a losing battle over the arrogation of power by incumbent management who put in place, or lure their shareholders into enacting, showstopping barriers of various effectiveness in the control takeover game. Federal regulatory supervision cannot, and perhaps should not, move beyond disclosure to substantive scrutiny of bids or defenses, and substantive state supervision is fighting a constant battle against commerce clause and supremacy clause negation.²⁶⁸

There are not, in my opinion, any patent answers to the question of the appropriate role for law and of legal institutions in this situation. Some flexibility even to the point of allowing some stock issuances differentiated as to financial and voting rights clearly is warranted, and certainly arguments about the macroeconomic morality of these transactions are not only legitimate but inevitable.

Whatever a political consensus might achieve in bringing clarity about the macroeconomic consequences to the reorganization field, private law—essentially a common law only nominally derived from general corporation codes—cannot escape its responsibilities, however modestly it may view its contributions and its organizing visions. If nothing more than care in the application of the business judgment rule is achieved, if no more in the way of specific doctrine than distinctions between urgent

²⁶⁶ See Buxbaum, *supra* note 10, at 525-42.

²⁶⁷ See, e.g., Coffee, *supra* note 172, at 1212-15, 1250-94 (discussing sources of market inefficiencies in the takeover process and proposing regulations to promote a competitive auction market for corporate control); Lowenstein, *supra* note 169, at 268-309 (discussing imperfections in the market and their effect on takeovers).

²⁶⁸ See *supra* note 264.

and nonurgent responses is developed, those alone would be a worthwhile and sufficient harvest for the state judiciary today.

In the long run, a private sector economy is not well served by judicial approval of institutions that erode the confidence of savers and investors. As ownership of private firms in any event devolves more and more to institutional investors, and as more and more institutional investors become intermediaries for the involuntary, pension-oriented savings of employees, this question of public confidence takes on even larger dimensions.²⁶⁹ Corporation law, even its most traditional, "internal" elements, becomes public law under these realities. That may have consequences for the traditional division of powers between state and federal authority, though these have not been my concern here. The concern of this Article has been to recall the significance of the internal division of corporate powers to both the judges and legislators who evaluate these corporate governance arrangements and the private parties who shape them.

²⁶⁹ For a brief review and evaluation of these trends toward separation of the decisions of how much to invest and where to invest it due to the emergence of institutional investors, see Clark, *supra* note 7. The recent experience of Unocal during its fight against the Mesa Group's takeover bid highlights the effects of institutional investors upon owner-manager relations. In return for their loyalty to management in the proxy fight, institutional investors extracted from Unocal a firm commitment to purchase back about thirty percent of its outstanding stock at a premium. Cohen & Rose, *Unocal is Seen Gaining on Mesa in Proxy Fight*, Wall St. J., May 10, 1985, at 5, col. 3 (e. ed.); see *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 951 (Del. 1985).